UNIVERSITY OF WASHINGTON SCHOOL OF LAW
GRADUATE TAX PROGRAM

TAXATION OF TRANS-PACIFIC TRANSACTIONS (T-536)

OVERVIEW OF THE PRACTICE OF INTERNATIONAL TAXATION

WINTER 2017

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COURSE DESCRIPTION

An introduction to practicing taxes internationally with a principal geographical focus on the Asia-Pacific region. The practice of international taxation requires a combination of both knowledge and mental processes. Knowledge includes international tax principles and mechanisms and how various countries implement them. Mental processes include the approaches and skills required to analyze a cross-border business or investment, identify the relevant issues, arrive at alternative approaches that resolve the issues, and help the decision-maker reach conclusions. In particular, the course participants will be learning and using the processes of researching and dealing with practical international tax problems and opportunities.

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WHAT IS INTERNATIONAL TAX PLANNING?

"International tax planning is the art of arranging cross-border transactions with the knowledge of international tax principles to achieve a tax effective and lawful routing of business activities and capital flows. The planning process follows the money flows in cross-border transactions, as they pass from the host [or source] country where they arise to the home country where they eventually end. Tax planning helps to reduce the cumulative impact of taxation, as compared to the separate tax incidence in the countries through which the transaction flows. Its prime objective is to receive the after-tax flows of overseas income lawfully at minimal cost and risk." [Roy Rohatgi, <u>Basic International Taxation (Second Edition), Volume Two, Practice of International Taxation</u>, BNA International Inc., 2007, page 1.]

While this is a good summary definition, a real understanding of what this means will only come through discussion of, and especially participation in applying, international tax principles and tools to real-life situations. During this course, you will be deeply involved in both this "discussion" and "participation".

WHY IS INTERNATIONAL TAXATION IMPORTANT?

Businesses and investors must conduct their cross-border commercial activities and investments in an efficient fashion that maximizes their after-tax profits while minimizing commercial, legal, and tax risks. To demonstrate how important this can be, the following case study example sets out a real-life cross-border commercial situation and assumes that the taxpayer (X) has conducted no international tax planning. We will go into detailed discussion of this during the first class session.

<u>Engineering and construction company case study</u>:

Engineering and construction company (X) is a country A company and is subject to country A taxation on its worldwide taxable income. Company X has an engineering and construction contract to be performed at a construction site in country B for its country B client (Y). There is no tax treaty between countries A and B.

Assume that X conducts no international tax planning and simply performs its obligations under the contract in its own name and through its own employees and assets (e.g. construction equipment, engineering know-how and other intangibles). Assume further that country B's taxing authorities see the construction site in country B as well as the full contract price which is paid by Y, a country B resident. In such a case, the country B taxing authorities will typically attempt to tax X's entire net income from the contract at country B's regular tax rate on net income. Other charges such as value added tax, import duties, and locally imposed taxes will of course apply as well. Country A's domestic tax rules apply as well to all of X's activities and income, including of course those being taxed by country B.

Even if country A's tax rules allow either a tax exemption on the earnings of a foreign branch or a foreign tax credit against country A's tax for the country B tax paid, the

country B taxes may be artificially high in comparison to the country A taxes resulting in significant unrelieved double-taxation. These artificially high country B taxes can arise, for example, from the following:

- X uses in its work for Y significant engineering know-how and other intangibles that it developed over a period of many years through extensive R&D and through many varied projects for numerous clients. Although these R&D expenditures are (or were) deductible in calculating country A taxes either as incurred or through amortization, it is unlikely that country B would allow any of these expenditures to be deductible against the income earned under the contract with Y.

- Both during the bidding process to win the contract with Y as well as during the course of its work, the management of X (as well as various support functions) will significantly contribute to the project. Support functions can include treasury, accounting, legal, tax, human resources, training, etc. Although economically some reasonable portion of the costs of management and these support functions are economically allocable to the Y contract, the country B tax rules may severely limit or prohibit the deductibility of these indirect costs in arriving at country B taxable income.

- Country B is attempting to tax all of the net income associated with the Y contract. And this includes income that arises from work performed by X personnel within country A or in some third country. For example, engineers and designers working in country A may conduct architectural and design work including the preparation of the blueprints required for the facility to be constructed in country B. Such taxation could arise from country B's sourcing of such income based on the work being incidental to the project in country B or from country B's aggressive apportionment of all or the bulk of the profit to the activities conducted within its borders. In any case, if the country A tax authorities regard this architectural and design and blueprint preparation work as creating income sourced in country A because the work was performed there, then there will likely be no ability to either exempt that income from country A tax or claim the country B tax thereon as a foreign tax credit against the country A tax.

- The country A employees of company X may become subject to individual income tax in country B on their wages earned while working on the project in country B.

Bearing in mind the dual objectives of maximizing after-tax income and achieving corporate goals, with appropriate planning, X might decide to break up its activities on this contract (and the net income there from) among some number of separate legal entities. These entities could be established in country A, in country B, or in some third country. Some of these entities will be taxed by country B while others may be taxed either solely in country A or solely in some third country. Further, some income

that is taxed in country B may be subject to tax at lower withholding tax rates applied to gross income instead of the normal country B tax rate on net income. This planning will of course affect in some favorable or unfavorable manner the other abovementioned country B charges (e.g. VAT, import duties, etc.) as well as potentially country A's taxation (e.g. potential deferral of some country A taxation).

Tax Goals Include:

- Deferral or Reduction in Domestic and Foreign Taxation (including all taxes, e.g. income, withholding, employment, VAT, import duties, business taxes, etc.)

- Utilization of Foreign Taxes as Foreign Tax Credits (or maximization of exempted income for home countries that apply an exemption system rather than a foreign tax credit system)

- Financial Statement Effect for Public Companies (i.e., minimizing the level of income tax expense including elimination of home country income tax expense on low-taxed foreign earnings permanently reinvested outside the home country)

- Minimization of Risk from Assessments, Penalties, etc.

Legal and Business Goals Include:

- Simplicity for Operations, Operating Personnel, Customers and Suppliers\

- Simplicity for Legal Documentation of Transactions

- Simplicity in Accounting for and Reporting of Transactions

Achieving tax goals may require complexity and risk that is inconsistent with a taxpayer's legal and/or business goals. Only if the international tax planner fully understands the taxpayer's business and philosophy will he be able to develop strategy that reasonably balances these various goals. In particular, see Section X below.

HOW IMPORTANT IS INTERNATIONAL TAXATION IN RELATION TO THE CONDUCT OF BUSINESS ACTIVITES?

In the purely domestic context of one country, the legal and tax formats of many types of transactions are relatively fixed and well known such that plenty of boilerplate structures exist for them. Standard corporate, partnership, or other structures and contracts are often easily obtainable. In the cross-border arena, however, the varying rules and customs in the various countries generally mean that all but the most common of transactions must be individually planned and structured. It is normally not enough for several business executives from the negotiating companies to merely agree on the economics of their deal. Rather, efforts to understand the effects of each country's taxation, duties, and other charges are integral to the economics of a contemplated transaction. Further, planning to reasonably minimize these taxes

and other costs to the parties often requires that the planning be completed before contract drafting is completed and the contracts are signed. As a result, tax considerations should be an important part of the preparation for negotiations and of the negotiations themselves.

As a very simple (and real) example of the need to plan ahead of time, a company planning to acquire by purchase a Chinese company spoke only to a local Hong Kong law firm that helped the acquirer restructure its existing Hong Kong companies that would then make the acquisition. The law firm had no tax expertise and gave no consideration to possible tax consequences. As part of their work, the law firm arranged for the transfer of shares in one of the Hong Kong companies for a sales price of nearly US$50 million. Unexpectedly, the acquirer was presented with a Hong Kong stamp duty charge of approximately US$100,000. This was money that could have been saved had the acquirer discussed its plans with its tax advisors in addition to its corporate advisors.

Using above engineering and construction company X as a further example, in the absence of upfront planning, X and its client Y will likely sign one contract for all products and services. Had X made the effort to plan ahead, it might have been able to tailor the contractual arrangements with its client Y so that its tax minimization objectives are achieved. For example, perhaps one contract between Y and an engineering subsidiary of X in country A would cover solely engineering services performed in country A. Another contract between Y and X's locally incorporated construction subsidiary in country B might cover the construction services and any locally performed engineering. Another contract between Y and a trading company in the X group might cover the sale of tangible personal property used in the construction. Such arrangements of course can not only save X considerable costs, but it may be able to lower X's overall charges to its client Y thereby making X more competitive. This sort of up front planning can be particularly important in competitive bidding situations. (See Section G below for additional discussion.)

To summarize, a lack of attention to taxation in cross-border transactions can cause an otherwise good business transaction to be of only marginal value or to even lose money after tax costs are considered. Further, in any bidding situation where a company is competing against other bidders for a contract, an economic advantage arising from good international tax planning can be the difference between success and failure on the bid. A final point of course is that a lower effective tax rate will increase a company's earnings per share…and that makes a difference to share prices.

HOW IS INTERNATIONAL TAX PLANNING ACCOMPLISHED?

Being aware of motivation

Before focusing on methodology and international concepts, structures, and techniques, it is worthwhile to say something "big-picture" regarding differing motivations for tax planning.

In a manner of speaking, there are two types of tax planning. Under one type, the taxpayer has non-tax business or investment objectives that will require interaction and transactions with third parties (e.g., hiring new employees, purchasing equipment, entering into a new market, borrowing or raising funds from unrelated banks or investors, loaning money or purchasing stock in an unrelated company, etc.). In putting these objectives into effect, the taxpayer must consider how best to organize and structure things through new or existing group companies and through effective contractual arrangements. Here, the business/investment objectives and all the facts that surround those objectives define the legal and tax issues that will be faced and help the taxpayer make decisions that will balance factors such as customer/supplier terms and relationships (e.g. which entities will purchase from suppliers and sell to customers, where will title to goods pass, etc.), possible locations where business functions will occur, desired minimization of business paperwork and other red-tape, etc.

Under the second type of tax planning, there are no significant non-tax business or investment objectives. Rather, the objective is a reduction in the level of taxation imposed on some aspect of currently conducted operations. In such planning, there is no significant change in the physical operations or in relationships with third parties; rather, there is change only in the internal group entity and contractual structuring. Perhaps one of the best-documented examples of this is the Caterpillar Swiss tax strategy that was implemented starting in the late 1990s. It had the effect of moving a significant portion of profits from the sale of certain Caterpillar spare parts out of the US where the bulk of business functions occurred and into a Swiss partnership owned by Caterpillar non-US group members. In the words of the Permanent Subcommittee on Investigations of the US Senate Committee on Homeland Security and Governmental Affairs, which held hearings focused on this Caterpillar Swiss tax strategy on 1 April 2014:

> Under the Swiss tax strategy, in exchange for a small royalty, Caterpillar transferred rights to the profits from its profitable international parts distribution business to a wholly controlled Swiss affiliate called CSARL. Caterpillar essentially redirected the profits by simply replacing its name with CSARL on its invoices. No personnel or business activities were moved from the United States to Switzerland, and most of the parts business remains in the US. [From https://www.hsgac.senate.gov/subcommittees/investigations/media/subcommittee-exposes-caterpillar-offshore-profit-shifting.]

The Majority Staff Report issued in connection with these hearings provides considerable detail and is well worth reading or scanning. It is available at http://www.hsgac.senate.gov/download/report-caterpillars-offshore-tax-strategy-april-1-2014.

In comparing these two types of tax planning, the take-away is that in the first type, the legal and tax issues and potential planning are defined by the business and investment objectives. In contrast, in the second type, taxation is the objective so that the need to make the tax planning successful is what defines any changes that must be made in the conduct of the taxpayer group's existing business or investment. The real constraints affecting such planning are typically the additional administrative steps that may be required (e.g. additional legal entities, documents, etc.) and internal requests that operational personnel must change their business processes or procedures to some extent (e.g. change existing customer contracts so that a different group member makes sales and earns revenue from the customers). Operational management and line personnel are typically less than enthusiastic about making any changes to established procedures.

The methodology and international concepts, structures, and techniques described in this paper for the conduct of international tax planning will not normally change significantly between these two types of tax planning. However, the international tax practitioner must be aware of what is motivating his work and how that might affect his analysis and advice as well as the taxpayer's reactions to that advice. Although this aspect is something that you can only learn in depth over a period of years, the sooner that you recognize this difference and make it a part of the background to your analyses, the better you will be as a professional.

Methodology for approaching cross-border tax planning

While any domestic tax planning of course requires a disciplined mind and attention to applicable law and factual details, international tax planning requires a perhaps more careful and methodological approach due to the exponential increase in factual and environmental variables that occur in the international arena. Such an approach follows:

- Step 1—Understand the background and facts relevant to the specific business and any intended transaction(s) (see Section A below)

- Step 2—Understand the environment of the country(ies) where the business or other activities will be conducted and/or where legal entities are established or are resident (see Section A below)

- Step 3—Identify relevant questions and issues that face the taxpayer(s)

- Step 4—Determine alternative approaches that will resolve the issues and be responsive to the taxpayers' needs

- Step 5—Help the decision-makers reach conclusions

- Step 6—Work with the taxpayers to implement their decisions

Concepts, structures, and techniques

In the remainder of this section of the paper, we cover various concepts, structures, and techniques at an "overview" level. We will then cover selected topics in greater detail in class discussion and will demonstrate them in real life situations through examples and case studies when appropriate.

A. Understand the background: The business and the environment

The business

Tax rules do not exist in a vacuum. They only have relevance in connection with an actual or contemplated transaction. As such, you must know and understand all background and facts to the relevant business and intended transaction. Only through knowing such will you be able to identify relevant issues that need to be resolved.

To summarize very briefly, "all background and facts" can include, without limitation, some or all of the following:

- A description of the business and its processes (e.g. manufacturing and sale of a product, performance of a service, where management decisions are made, etc.)

- The number of employees, their locations, their functions and activities performed in each location, and the identities of the group members that employ them

- The location of manufacturing or other facilities and the location of sales and other offices (including warehouses where inventory is maintained, representative offices, customer service centers, technical support facilities, etc.)

- The legal structure of the group of companies if there is more than one legal entity including an organization chart or other description that shows the ownership and country of incorporation of each legal entity, the location of board of directors meetings or other central management activities, the location of branch offices and representative offices of each legal entity, the allowable business scope of each entity or branch, and the specific business activities conducted by each legal entity, branch, or representative office

- The ownership of the overall group (e.g. publicly listed, closely held, in which countries the owners are resident, etc.)

- The location of suppliers/vendors, the goods or services being supplied, and the terms under which such are provided

- The location of customers, including unrelated distributors, and the terms under which sales are made (e.g. who is importing product)

- The location of any agents, their activities, and the scope of their authority to act on the principal's behalf

- The location of clients (of a service business) and the locations where services are performed for the clients including the nature of the services performed at each location

- The intellectual property owned and used including its nature, which group entities own it, which group entities utilize or benefit from it, in which countries it is utilized, and what license or other agreements deal with it

- In regard to all of the above, all relevant contracts and other documentation

As a framework within which to organize one's thoughts when asking questions about a business and its factual background, it can be useful to use the following aspects and "flows" that occur within any business. These aspects and flows are:

- People

- Intellectual Property

- Product and/or Service

- Cash and Other Financial Arrangements

- Legal Documentation

By thinking carefully through each of these five bullet points and diagramming them and/or mapping them in an organized fashion, the tax professional can see where his understanding of the facts is incomplete. He can then request appropriate documents and develop further questions for relevant personnel, the answers to which will provide a full and complete understanding of the business and any specific transaction at issue.

Assume that you're a tax lawyer helping one of your law firm's clients. Facts about the client's business can only be obtained by reading relevant documents and speaking with client and other knowledgeable personnel. It must be remembered that most client personnel do not know what is important to you. For example, operating personnel typically think along product or service lines and not along legal entity lines. Unless asked, they will seldom voluntarily distinguish which legal entity is performing a particular function, owns a particular asset, or is employing the personnel performing the function. Even many financial personnel, particularly in the US where relatively less attention is paid to which entities perform which functions (due to some extent to the consolidated federal income tax filings), will have little understanding of what background and facts you really need. You must be sensitive to this and ask searching questions, following up as appropriate.

To thoroughly understand the business, persons with knowledge from the following departments will typically need to be involved. The level of involvement of each will of course depend upon the nature of the particular project.

- Operations
- Research & Development
- Trade
- Sales & marketing
- Legal
- Accounting
- Taxation
- Human resources
- Treasury
- Investor relations
- IT
- Logistics

In pursuing your career, you'll want to consciously develop your ability to talk to people and ask relevant questions. Your skills will develop with time and experience. It may be added that one of the best ways to encourage people to talk is to be genuinely interested in their company and its business. People like to talk about their business and will take extra time and care in what they cover when they see such interest.

<u>The environment</u>

The environment of a business or investment includes both tax and certain non-tax laws and regulations in each country in which the taxpayer operates. Perhaps the primary non-tax law that will most often be relevant is the local companies act or other laws that define the various types of entities, what they can do, how they can be owned and controlled, etc. In addition to the pure legal issue of what entities exist in a country and their respective characteristics, a country's business traditions and common usage may be relevant as part of the background. For example, in Japan, the use of a Kabushiki Kaisha (KK) for a new subsidiary may be dictated if the alternative of using a Godo Kaisha (GK) is ruled out due to the nature of the business to be conducted. Although this has been changing to some extent in recent years, the use of a KK has historically implied a greater commitment to being in Japan and was often important to customers, employees, and suppliers. Even today, it might be the case that the use of a GK would be such a negative in the minds of these people that it affects the ability of the business to be successful.

As one example of the importance of non-tax laws, the companies law in a number of countries will only recognize that a contribution by a shareholder is to be treated as a contribution to capital if shares are issued to the shareholder in connection with the transfer. As a result, a transfer of cash or other property by a parent company to its subsidiary that is not documented as a loan or for which no shares are issued may result in taxable income being recognized. As another example, if you conclude that a taxpayer group of companies would be better off merging several operations that are each conducted in a different legal entity in order to be able

to offset gains and losses, then the terms of any local laws and regulations regarding business combinations will determine what legally can or cannot be done. Or, as a further example, if you decide that placing a holding company over several operating companies makes sense, then any local rules applicable to holding companies must be examined. Some countries have detailed rules on what holding companies may or may not do.

One other aspect of the environment within each country is the degree to which there is a true "rule of law" in practice. "Rule of law" refers generally to the extent that the local government and tax authorities actually respect and follow their own laws and rules as opposed to their taking arbitrary actions that are not based on laws or other written and consistently applied rules. Within Asia, there is a reasonably broad "rule of law" spectrum within which the various countries fall. Within China there are many national-level rules drafted in relatively unclear language. As such, local tax bureaus and other regulatory bodies in enforcing these national-level rules often have wide latitude so that widely differing treatments will be found throughout the country. As stated in an article on Chinese taxation: "[C]haracteristics [of the Chinese taxation system] include: the coexistence of formal taxes, sundry levies and hidden taxes; legislation without a democratic mandate; law-making and administration by numerous authorities and a multiplicity of tax jurisdictions; … difficulty in implementing issued tax laws uniformly, with execution often dependent on locality and taxpayer status." Eva Huang & Bin Yang, "Characteristics of the Chinese Tax System and its Cultural Underpinnings: A Comparison with the West", 1 J. Chinese Tax & Pol'y 13 (2011). (This article, which can be found on the course website, includes a summary of Chinese cultural considerations beginning on page 27.)

Another aspect of environment is the existence or lack of existence of effective courts and appeals mechanisms for tax issues. While many countries do have an effective appeals mechanism where differences of opinion can be fairly adjudicated, some countries have less effective systems or have systems that are seldom used. China has been a good example of the latter. Wei Cui, in several articles, describes an environment in which most taxpayers are able to deal person-to-person with their local tax inspector on tax reporting matters so that issues and potential disputes get resolved and are seldom elevated into formal administrative appeals or the judicial system. While there is an increasing number of reported and publicly available judicial decisions, for the most part they do not provide sufficient background facts to judge the quality of the legal analysis. Professor Cui comments that while there will often be a deference for views and practices of the Chinese tax authorities, he has not seen anything that would cause him to question the basic competency of Chinese judges or that they exhibit a blind bias for tax authority positions. (See Cui, Wei, "Administrative Decentralization and Tax Compliance: A Transactional Cost Perspective" (December 11, 2014), University of Toronto Law Journal 65(3), pp. 186–238, available at SSRN: https://ssrn.com/abstract=2536881, and Cui, Wei, "Does Judicial Independence Matter? A Study of the Determinants of Administrative Litigation in an Authoritarian Regime" (August 25, 2015), University of Pennsylvania Journal of International Law, forthcoming, available at SSRN: https://ssrn.com/abstract=2707436.)

For guidance on these issues generally within a country or specifically with respect to a particular type of contemplated transaction, local tax counsel is necessary. It should be added that the practices of authorities can change over time. As a result, this type of environment

issue should be revisited periodically with local counsel as well as any time it becomes important.

This course is primarily focused on income taxation. However, international planning must take into account many other taxes and charges. Typically, the more important of these are value added taxes, import duties, business taxes on gross receipts, capital charges, and stamp duties. See Section W below for a listing of such taxes and charges.

The above paragraphs in this section on environment focus primarily on the conditions in the country in which a transaction or business operations will take place. In addition, law and other factors within the home country of the corporate group or investor or in intermediary countries where holding companies or other functions take place may be important as well. These could include home country tax issues such as controlled foreign corporation (CFC) rules (see Section C) or an aggressive transfer pricing regime as well as non-tax issues such as home country securities and anti-corruption laws. The US, for example, has corrupt practices and boycott legislation through which it attempts to influence the actions of its residents and their overseas subsidiaries. Regarding the former, penalty payments of more than $1.5 billion were paid by corporations in 2014. (See http://www.justice.gov/opa/speech/assistant-attorney-general-leslie-r-caldwell-delivers-remarks-american-conference.)

B. Legal tax planning vs. unacceptable tax evasion; Assessment of risk

You have spent several years obtaining a J.D. plus much effort in your Tax LLM studies to allow you to tell the difference between legal tax planning and unacceptable tax evasion in the US. You've also presumably studied the various penalty sections and have become familiar with terms such as "fraud", "negligence or disregard of rules or regulations", "substantial authority", "reasonable basis", "more likely than not the proper treatment", "unless it is shown that such failure is due to reasonable cause and not due to willful neglect", and "transaction lacking economic substance". You also know the mechanisms available to contest an IRS agent's determination both administratively within the IRS as well as through the US's court systems. And you've been introduced to the requirements of Treasury Department Circular No. 230 and perhaps the tax return preparer penalty provisions as well. As a result of all this studious effort, you can give intelligent advice to a client on the various benefits and risks of differing interpretations of the US tax law as applied to a specific transaction and/or person.

Most countries have a penalty regime. In some, the regime is fairly simple and straightforward. In others, like the US, it's relatively complicated. It is fair to say that most other countries do not have as complicated a penalty regime as the US. While this may be true, though, it does not mean that these regimes are unimportant. Rather, what is important is that the tax professional and his client understand sufficiently these regimes and their implementation by local tax authorities to be able to assess the risk of taking a more beneficial tax position when there's a choice of several—even if the position chosen does not seem particularly aggressive on the surface. For example, some countries impose penalties irrespective of the strength of the legal arguments supporting a taxpayer's position. Also, the base for some penalties may be the amount of income under-reported rather than the amount of tax underpaid. This can cause

penalties to arise even when there is no tax due, perhaps because of operating losses or a tax holiday. By contrast, some penalties imposed under US tax law are based on the amount of tax underpaid, meaning for example that where there are tax losses or where sufficient pre-payments have been made, there may be no penalty.

Typically, amounts assessed as penalties in a local country are not creditable under foreign tax credit regimes in the home country, and may as well not be deductible as expenses in calculating home country taxable income. And where the home country has an exemption system applicable to foreign source income, penalties that relate to exempt foreign source income will normally represent an extra cost with no tax benefit (i.e., no credit and no deduction in calculating home country tax liability). Considering this, where there are significant penalties at issue if a beneficial tax position is taken in a local country, the assessment of risk becomes a critical step in the client's decision-making process. It may be added that the tax authorities in some countries will "leak" to the press news of large tax assessments or other information about recalcitrant taxpayers that can be embarrassing and damage business reputation. In recent years, the press has been active in identifying large corporations that have shifted profits out of the countries in which they operate with one Bloomberg reporter even winning a Pulitzer prize for his efforts. As such, the risk can go well beyond just additional tax, interest and penalties.

Most countries charge interest on late payments. Understanding how such interest is calculated is important, as in some countries, the rates may be quite high.

In advising your clients on cross-border transactions, you will of course be relying to some extent on professional advisors in other countries. Considering the high ethical and social principles that your clients conform to as well as their personal or organizational capacity (or lack thereof) for accepting tax risk, you must learn from those local professional advisors enough to allow you to make sure your client understands all possible consequences of his choices.

The environment that your clients find themselves in today reflects serious changes from the environment that taxpayers faced in conducting international business and investment just fifteen to twenty years ago. The changed environment partially results from the Enron and Parmalat debacles as well as the Sarbanes-Oxley legislation. Some of these changes may have started in the US, but numerous other countries have followed suit in an international ripple effect.

In more recent years, the successes of the international tax structuring conducted by many multinational companies, which have lowered corporate effective tax rates and eroded the tax bases of many countries, have spurred the G20 and the Organisation for Economic Co-Operation and Development (OECD) into additional actions. These actions, which seek to combat profit shifting by multinationals, ballooned into the two-year 2013 – 2015 "Base Erosion and Profit Shifting" project. See later section herein that provides background and some details on this BEPS project.

In the midst of this BEPS project, the International Consortium of Investigative Journalists in 2014 published a trove of leaked documents, referred to as "Lux-leaks", that included many

Luxembourg tax rulings on almost 350 multinational companies. These leaked documents, which were taken from the internal files of a Luxembourg member firm of PricewaterhouseCoopers International Limited, provoked significant reaction and outrage worldwide regarding the artificial nature of many tax structures. See http://www.icij.org/project/luxembourg-leaks. Further, in May 2016, the International Consortium of Investigative Journalists published the "Panama Papers", a massive searchable database providing leaked documents from the Panamanian law firm Mossack Fonseca. The website states that documents involving nearly 214,000 offshore entities are included in the database. See https://panamapapers.icij.org/blog/20160509-offshore-database-release.html. Finally, in September 2016, the International Consortium of Investigative Journalists announced a further cache of leaked documents involving 175,000 Bahamian companies. See https://www.icij.org/offshore/former-eu-official-among-politicians-named-new-leak-offshore-files-bahamas.

The European Commission has also joined in by examining corporate structures that often rely on tax rulings for "illegality" under the European Union's "state aid" rules. As of late 2015, the European Commission had announced decisions that the Netherlands and Luxembourg had illegally granted state aid to Starbucks and Fiat, respectively, as the result of transfer pricing rulings not based on market conditions but rather based on attempts to establish some level of taxable income. On August 30, 2016, the European Commission announced its decision on Apple that there had been illegal state aid granted by Ireland. The basis, while economically similar to the Starbucks and Fiat transfer pricing decisions, was not technically a transfer pricing decision. Rather, it was that Ireland had allowed most income to be allocated to a head office of Apple's non-tax resident Irish subsidiary so that it would escape any Irish tax. Since the "head office" had no office and no employees, the Commission found that this allocation did not correspond to economic reality. The Commission calculated that Euros 13 billion of tax for the past decade should be paid by Apple to Ireland. Ireland will appeal this Commission decision. (See "Friends With Tax Benefits: Apple's Cautionary Tale", Allison Christians, 78 Tax Notes Int'l 1031 (15 June 2015)). It is likely that future decisions will be issued for Amazon and McDonald's tax rulings granted by Luxembourg.

An early effort still ongoing was the drive to increase transparency through information exchange agreements. The following is from page 49 of a 2009 OECD book titled "Building Transparent Tax Compliance by Banks":

> The potential for a more effective exchange of information has significantly changed since the beginning of 2009. Today all OECD countries have endorsed the Article 26 standard [article in OECD Model Tax Convention dealing with exchanges of information between the treaty parties]. Major financial centers outside of the OECD such as Hong Kong and Singapore have also endorsed the Article 26 standard and there is now a spreading network of Tax Information Exchange Agreements [TIEAs]. More than 50 such agreements have been signed this year and many more are under negotiation. All these developments mean that countries are better equipped to obtain information from their partners.

By early 2013, the above-mentioned 50 TIEAs had risen to almost 800, and by late 2016, the number has risen significantly to over 1300. These TIEAs and the additional developments of the US Foreign Account Tax Compliance Act (FATCA) (enacted in 2010) and the Common Reporting Standard (approved by the OECD Council in July 2014) have put in place the mechanism for not only one-off exchanges of information but for the automatic exchange of information on various account data held by financial institutions and certain other parties. Further, the BEPS project and certain European actions have initiated country-by-country reporting and the transmission of tax rulings to certain other affected countries.

Things are starting to go significantly beyond just more transparency. In mid-2010, the then IRS Commissioner Douglas Shulman commented as follows about future joint audits in addressing the Business and Industry Advisory Committee to the OECD:

> As Chair of the FTA [Forum on Tax Administration, which brings together tax commissioners from more than forty countries], I am working with my international counterparts to build greater cooperation between tax authorities across the world as we strive to improve tax administration, both domestically and internationally.
>
> The commissioners of the FTA can also speak with a unified voice on such critical matters as offshore compliance, corporate governance and high net-worth individuals, as well as lay out practical solutions for issues, such as a coordinated approach to joint audits and early competent authority resolution….
>
> …we are now working on developing a protocol for joint audits with other countries. And before I go any further, let me be clear on a critical distinction. A joint audit is not a simultaneous exam. Rather, it is a process where two or more countries join together to carry out a single audit of a company with cross-border business activities.
>
> …both countries receive the same information and presentations from the taxpayer.
>
> … two or more tax authorities would hear the same facts, agree on the issues more quickly, jointly characterize a transaction, and agree on a treatment….

And on 6 December 2012, the European Commission in its "An Action Plan to strengthen the fight against tax fraud and tax evasion" included as a longer term initiative to be undertaken beyond 2014: "A methodology for joint audits by dedicated teams of trained auditors". See http://ec.europa.eu/taxation_customs/resources/documents/taxation/tax_fraud_evasion/com_2012_722_en.pdf.

While joint audits will take some time to become common and widespread, this is clearly a new and different future in comparison to the past. For example, past tax authority audit practice typically has involved separate audits of a taxpayer by a local country where a taxpayer might be operating and by the taxpayer's home country. Such a taxpayer is able to present his situation in the most favorable light to the local country tax authority auditor and is then able to support his home country reporting upon a later home country audit with a difference emphasis

or logic. Joint audits would truly create a new atmosphere and could require taxpayers to conduct more in-depth thinking and planning in many cross-border situations.

As a further development, on the reporting and compliance side, the Financial Accounting Standards Board (the private sector organization in the US that establishes financial accounting and reporting standards) issued in June 2006 "FASB Interpretation No. 48" (commonly known as "FIN 48" and now codified within Accounting Standards Codification 740-10 (www.fasb.org)). Under FIN 48, affected financial statement issuers must accrue and disclose uncertain tax positions, including in some cases the nature of the uncertain positions. All analysis of these positions must be made assuming that all facts have been disclosed to the relevant tax authorities. The low risk of a future actual audit cannot be a part of the analysis; in other words, a taxpayer cannot include "audit lottery" thinking in its analysis.

These FIN 48 rules affect issuers using US Generally Accepted Accounting Principles (typically referred to as US GAAP). For issuers using International Financial Reporting Standards (which includes issuers in much of the rest of the world), the International Accounting Standards Board has been considering this topic and issued an initial exposure draft of a new standard on accounting for income taxes in March 2009 that included a similar requirement (see paragraph 49 of ED/2009/2, Income Taxes). The International Accounting Standards Board's IFRS Interpretations Committee published its draft Interpretation "Uncertainty over Income Tax Treatments" ("draft Interpretation") in October 2015. If balloting over this draft Interpretation and further implementation steps proceed as scheduled, then its effective date will be 1 January 2019, with earlier application permitted.

What's a simple example of an uncertain tax position in the international context? Say for example that a US parent company has set up a wholly-owned Hong Kong subsidiary that conducts certain consulting services from its offices in Hong Kong. Say further that Hong Kong based consultants sometimes travel into China to service certain clients. Without going into detail, say that it is not clear whether the China/Hong Kong tax arrangement protects the Hong Kong company from the 25% Chinese enterprise income tax on profits from the consulting services performed in China. Further, if China were to assert tax on such profits, it is not clear how the tax base for China's tax would be computed. Assume that the Hong Kong subsidiary believes that it is not obligated to pay any Chinese tax and has not volunteered it. If all information were provided on a full disclosure basis to the Chinese authorities, it is possible that they would assess a tax liability. The decision by the Hong Kong subsidiary to not declare itself to be taxable in China is an "uncertain tax position".

Financial statements issued by a US publicly-held company will typically reflect a lower tax expense on its income statement for any uncertain tax positions where it is "more likely than not" that the company will sustain the beneficial tax position. Where this "more likely than not" test is not met (i.e. it's more likely than not that the tax authorities will win the issue), then the company will report on its income statement the higher tax expense even though its tax returns will be prepared on the more beneficial basis. This difference between the higher income statement tax expense and the tax liability shown on the applicable tax return will be reflected as a liability on the company's balance sheet, even though the company hopes to never pay it.

And the total amount of this liability, which is termed “unrecognized tax benefits”, must be separately disclosed in the financial statements.

Many US publicly-held companies in recent years have included in their financial statements material “unrecognized tax benefits” to reflect these uncertain tax positions where the “more likely than not” test has been failed. Interestingly, a law firm has been trying to attract as clients “whistleblowers” who would turn in damaging information on such companies to the IRS (or other relevant tax authorities) to earn a whistleblower reward. To encourage such potential whistleblower clients, the law firm has published on its website (http://www.tax-whistleblower.com/ferraro500/) a listing of the Fortune 500 companies in the order of the amount of the companies’ unrecognized tax benefits. In other words, how much has each company set aside as a liability for taxes that it might have to pay (but hopes not to) and for which the company believes that it has not met the “more likely than not” test. The following, which is from “The 2015 Ferraro 500”, gives just a few of the companies listed on the website and the amount of unrecognized tax benefits for each as of 2014. You will note the significant size of these recorded liabilities.

Exxon Mobile	$8.986 billion
Microsoft	8.714 billion
General Electric	6.529 billion
Pfizer	6.182 billion
AT&T	5.438 billion
IBM	5.104 billion
Wells Fargo	5.002 billion
J.P. Morgan Chase	4.911 billion
Entergy Corporation	4.737 billion
American International Group	4.395 billion
Hewlett Packard	4.128 billion
Apple	4,033 billion

Partially as a reaction to FIN 48, the US Internal Revenue Service (IRS) in January 2010 issued Announcement 2010-09. This document announced the IRS’s intention to require certain business taxpayers to disclose on their filed tax returns their uncertain tax positions. This significantly changed the previously existing IRS/taxpayer dynamic under which the IRS primarily identified tax issues that it wished to question on technical or other grounds through its very time- and resource-consuming audit efforts. And it also changed the “audit lottery” mentality that had been, as a practical matter, an important part of many tax planning decisions. In September 2010, the IRS issued finalized Schedule UTP and accompanying instructions indicating generally that corporate taxpayers with assets of $100 million or more would have to apply the new disclosure rules for the first time in their fiscal year beginning in 2010. This $100 million threshold has been reduced and is now $10 million for fiscal years beginning in or after 2014.

The US tax system has for many years included certain requirements or, one might say, gentle encouragements for full disclosure of tax positions including, for example, the “accuracy-related penalty” rules of Internal Revenue Code section 6662, the treaty-based position rules of section

6114, the tax preparer penalties of sections 6694 and 6695, and the abusive tax shelter penalty of section 6700. These, however, have been somewhat limited in scope and effect, relatively speaking. A more recent and perhaps broader "encouragement" to more conservative tax planning and full disclosure was the 2010 enactment as part of the Health Care Reform of high strict-liability penalties for transactions lacking "economic substance" as defined in Internal Revenue Code section 7701(o). In general, where a disclosed transaction meets this definition, then a 20% penalty will apply if the taxpayer's position is not sustained. Where there has been no disclosure, then the penalty is doubled to 40%. See further discussion on this 2010 development in Section Q below. In the words of the Joint Committee in JCS-3-09 (September 2009) on page 48: "By increasing the cost to taxpayers when a transaction is determined to lack economic substance, the codification and penalty regime intends to change the taxpayer's cost-benefit analysis and deter some aggressive taxpayer behavior."

To summarize, simply stated, the environment has changed. Whereas previously corporate CFOs, tax directors and their in-house and outside professional advisors typically only worried about additional taxes, interest and potential penalties that were normally somewhat limited in amount, now accounting and tax planning decisions or positions, even when clearly legal, can carry very much higher penalties and, more importantly, broader potential problems that can affect a company's business as well as its reputation and the light in which it is seen by customers, suppliers, investors and social activists. This has helped elevate concern about tax risk management above the traditional CFO level to CEOs and boards of directors. An OECD paper on Corporate Governance and Tax Risk Management ("Forum on Tax Administration, Information Note, General Administrative Principles: Corporate Governance and Tax Risk Management", July 2009) states on page 4: "How a large business manages tax risk can affect its financial performance and reputation. CEOs and Boards of large businesses are increasingly considering tax risk management as part of their overall corporate governance."

Evidence over the past decade of the broader potential problems includes:

- The public backlash and resulting 2004 legislation against tax-motivated corporate inversions

- The heightening governmental and public backlash in more recent years on inversions with some corporations that had considered it back-pedaling due to potential customer reaction (e.g. Walgreens) or the potential effects of regulatory actions (e.g. Notices 2014-52 and 2015-79) (see brief discussion of inversions in Section O on Tax Effective Locations)

- The SEC and investor reactions to the use of certain generally accepted accounting methods (e.g. accounting for IRUs in the telecom industry—"indefeasible right of use")

- The tendency of governmental authorities and others to act based on the merest unsubstantiated hint of impropriety (e.g. governmental agencies refusing to allow Arthur Andersen to bid on government work and audit clients deserting well prior to Arthur Andersen's indictment, much less its conviction on witness tampering charges or its exoneration by the US Supreme Court a few years later)

- The negative reaction of investors when a publicly held company subject to the Sarbanes-Oxley Act discloses "material weaknesses" in its internal control systems (e.g. when a US listed company has acquired a new subsidiary, say in China, and that subsidiary is found to have inadequate internal controls over its local tax obligations that must be disclosed in the US listed company's SEC filings)

- Due to highly successful cross-border tax planning by many multinational corporations, the establishment by the OECD Centre for Tax Policy and Administration of the two year 2013 – 2015 "Base Erosion and Profit Shifting" ("BEPS") project with encouragement by the G20 Leaders (see http://www.oecd.org/tax/beps.htm as well as the International Monetary Fund document on "Issues in International Taxation" found at http://www.imf.org/external/np/pp/eng/2013/062813.pdf)

- The public hearings, media attention, and activists' actions against Starbucks and other companies doing business in the UK as a result of low UK tax payments in comparison to their level of UK sales (see http://www.parliamentlive.tv/Main/Player.aspx?meetingId=11764&st=15:23:30&utm_source=Starbucks+Transfer+Pricing+Leaves+a+Bitter+Taste&utm_campaign=Starbucks+Constant+Contact&utm_medium=email, http://www.guardian.co.uk/business/2012/nov/12/starbucks-tax-avoidance-controversy?utm_source=Starbucks+Transfer+Pricing+Leaves+a+Bitter+Taste&utm_campaign=Starbucks+Constant+Contact&utm_medium=email, and http://graphics.thomsonreuters.com/12/10/EuroStarbucks.pdf?utm_source=Starbucks+Transfer+Pricing+Leaves+a+Bitter+Taste&utm_campaign=Starbucks+Constant+Contact&utm_medium=email http://www.publications.parliament.uk/pa/cm201213/cmselect/cmpubacc/716/716.pdf)

As a result of the above (which is by no means a complete listing), the risk of being wrong, if only in appearance, has changed. There are not only the traditional tax risks, there are also serious business risks. This affects how advice and the risk thereof must be presented to a client. It also means that the "smell" test has become more important. As a professional advisor, you must always step-back and think: "How would my client's position or my advice to my client appear in hindsight where all relevant facts are known?" Note in this regard the Starbucks situation in which their bad press appeared to hurt their reputation in the UK more than Nike's reputation was hurt by its continued association with Lance Armstrong until his doping revelations caused Nike to terminate that association. (See http://www.brandindex.com/article/starbucks-suffers-more-nike.) Eventually, Starbucks announced that it would pay corporation tax, pledging in an open letter:

> And while Starbucks has complied with all UK tax laws, today we are announcing changes that will result in the company paying higher corporation tax in the UK. Specifically, Starbucks will not claim tax deductions for royalties and standard intercompany charges. Furthermore, Starbucks will commit to paying a significant amount of tax during 2013 and 2014 regardless of whether the company is profitable

during these years. [See http://www.starbucks.co.uk/blog/an-open-letter-from-kris-engskov/1249 and http://www.starbucks.co.uk/our-commitment.]

The above-mentioned developments focus on what taxpayers face. In addition, there has been a trend in the US to focus attention and punishment not only on the taxpayer but on tax professionals and other facilitators of taxpayer abuses. The following is from Scott Schumacher's 2013 article "Magnifying Deterrence by Prosecuting Professionals", University of Washington School of Law Legal Studies Research Paper No. 2013-17, pages 3-4. (Find it at: http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2243093.)

> …beginning with the tax shelter prosecutions in 2005, the government's policy of restraint has undergone a significant change. Rather than challenging abusive transactions civilly or prosecuting the taxpayers, the government began focusing its criminal resources on the professionals who advised and enabled their clients to evade or avoid taxes. Thus, instead of pursuing taxpayers who claimed hundreds of millions of dollars in phony losses, the government decided to go after the accounting firms, law firms, and the professionals who advised these taxpayers. And these were not just any firms. The government proceeded criminally against professionals from some of the leading law and accounting firms, including KPMG, Ernst & Young, Brown & Wood, and Jenkins & Gilchrist. These cases garnered mixed results for the government, with the government getting some notable victories, but also some high-profile losses. In the process, however, the government effectively shut down the tax shelter industry and fundamentally changed tax practice. [Footnotes omitted.]

In recent years, there has been considerable US Department of Justice effort to penalize Swiss banks with large fines and significant bad publicity for their helping US taxpayers avoid US tax. See http://www.justice.gov/tax/offshore-compliance-initiative.

The attention on professionals has not only been in the US. On 31 January 2013 the UK Parliament Public Accounts Committee held hearings on how the major four accounting firms encouraged tax schemes. It made for a relatively entertaining broadcast. See both http://www.parliamentlive.tv/Event/Index/99471175-8843-4957-81be-1a40d99ca8f9 and http://www.parliament.uk/business/committees/committees-a-z/commons-select/public-accounts-committee/news/report-tax-avoidance-the-role-of-large-accountancy-firms-follow-up/.

With the above in mind, a few practical comments on the management of tax risk are in order.

Whether planning for a contemplated one-off transaction (e.g. a merger or acquisition) or for on-going business operations (e.g. initiating product sales into a new country or reorganizing an existing supply chain), the financial and tax consequences must be adequately understood through timely planning and analysis. Anticipated consequences and related benefits and risks concerning all taxes, excises, duties, exchange controls, etc. must be fully and consciously understood. In addition, on an on-going basis, multinational groups should monitor the relative profitability or level of loss within each group member to identify where various tax authorities might have reason to question inter-company transfer pricing and/or intra-group relationships.

This has become increasingly important with the anticipated Country-by-Country Reporting that will be commenced for 2016 financial and operation information as a result of the BEPS project.

The above leads to a need to not only understand the various types of risks, but also to identify the person or group within the client organization who must understand and sign off on the benefits and risks being accepted. Where a client has not already done so, the client should be encouraged to squarely face their need to deal with tax risk and to document how it is to be handled in an internal written policy. Working with a client that does not understand the risks it is assuming is particularly risky for the professional who is attempting to advise it.

An interesting recent development that reduces risk both for tax authorities and taxpayers is the "enhanced relationship" concept that grew out of the OECD's Forum on Tax Administration. Under this approach, a country's authorities and the taxpayer attempt to work together on an on-going basis to resolve areas of uncertainty before tax returns are filed and thereby reduce the time-consuming and potentially costly adversarial process that has typified the tax authority/taxpayer relationship for so long. In the US, the IRS implemented the Compliance Assurance Process (CAP) program about a decade ago and has been expanding it. Some other countries, such as the Netherlands and Australia, have initiated it as well and others are developing similar pilot programs.

Types of risk facing taxpayers include the following:

- Interpretational risk—The interpretation of tax laws/regulations/rulings/etc. and how they are to be applied to specific fact patterns has been a part of professional tax practice for as long as there have been taxes. Explaining these types of risks to clients has been our bread-and-butter work.

- Implementation risk—We may provide excellent advice to our client on how they can proceed to structure a transaction or operate their business so as to achieve certain tax related goals. However, unless we are a part of the implementation process and review each step and all documents, there can be considerable risk that what gets executed will differ from what was recommended.

- Changing facts—The manner in which a business operates changes over time based on the needs of its customers and the actions of operating management. Unless tax personnel are monitoring the changes (preferably well before they occur), high tax risk may result. Perhaps the most obvious example of this is transfer pricing on related party transactions. Pricing established at one point in time may no longer be supportable as market conditions change. A less well known, but very common example of "changing facts" in the international tax arena is where a company from one country (country A) has set up a representative office in another country (country B) to facilitate sales of products to country B customers. Under the rules of country B, as long as the representative office limits its activities in a proscribed manner, then there will be no country B corporate income taxation on the company sales to country B customers. As customer needs expand, assume that the representative office begins to provide technical support services in connection with the products sold to country B customers.

Such an operational change may potentially cause the company to be taxable in country B not only on any income earned from the provision of technical services, but also on some or all of the gross profit earned on the sale of products to country B customers.

- Compliance risk—The day-in/day-out requirements of complying with tax return filings, estimated tax payments, withholding tax payments and filings, value added tax payments and filings, etc. requires significant management and control. Where such is lax or where there is inadequate on-going communication between operating personnel and tax personnel, material risks can result. These risks can be particularly acute in overseas locations where there are primarily operating personnel and few financial employees. Typically, many multinational corporations will have no local tax personnel of their own and will rely solely on local professional lawyers and accountants for compliance and planning. It can easily happen that such local professionals are not kept informed of business changes and other developments.

- Reputation risk—Media knowledge, and therefore public knowledge, of tax disputes can occur in any country when tax issues are aired through court filings or other documents that are in the public domain. The tax authorities in some countries, though, have made active use of the media to whom they will leak information on specific taxpayers whom they wish to pressure into agreement.

  Japan has been sufficiently well known for such pressure tactics that the US government has even been a defendant in a case charging that "the IRS knew or should have known that the NTA [the Japanese National Tax Administration] would not treat the information [the IRS had provided to the NTA] in accordance with the secrecy provisions of the Treaty". Specifically, "Plaintiffs claim that Defendant violated section 6103 by providing confidential tax information, whether false or true, to the NTA because the IRS knew or should have known that the NTA would leak the information." Following the transmission of information, stories appeared in the Japanese media regarding the examination and including some of the information provided. See *Aloe Vera of America Inc. v. United States* No. CV-99-01794 (February 11, 2015) *2015 WL 567003*, *Aloe Vera of America Inc. v. United States et al.* No. 10-17136 (submitted May 9, 2011), *2011 WTD 192-26* and *Aloe Vera of America Inc. v. United States et al.* No. CV 99-1794 (Feb. 2, 2007), *2007 WTD 27-22*.

- Financial statement risk—This category of risk includes two principal issues. First, there is the potential for unexpected material income statement charges for increased taxes and penalties, the amounts of which affect earnings per share and share price. Second, there may be penalties and significant public embarrassments from failing to achieve the documentation and internal control requirements of the Sarbanes-Oxley legislation in the US or of similar legislation that has been enacted in some other countries. Self-disclosure of deficiencies in a company's control of its own tax accounts or any need to restate any prior years' financial statements for material errors would be seriously embarrassing to both its management and the board.

The above discussion focuses primarily on the risk that our clients face or that our employers face if we are working in an in-house position. As individuals, though, we face risk both professionally and personally if we give wrong advice or if we are unable to effectively communicate our advice to our client or employer. This risk of course extends as well to any law or accounting firm within which we work. With this in mind, two practical points are worth briefly noting.

- A professional must apply intellectual honesty to determine what he knows and what he does not know. In discussion with, or in any applicable written communication to, a client, a professional must make clear what he does not yet know but will, if appropriate, find out and get back to the client on.

- The professional must identify the decision-maker and must assure that he has effectively communicated the benefits and risks of any matter to that decision-maker. If there is not a letter or other written communication to the client that covers these, a professional must internally document the benefits and risks that he has verbally communicated to the client.

In regard to this second bullet-point about the identity of the decision-maker and documentation, an important potential risk to the professional when working within a company or with client management personnel is noted in the later section of this paper concerning the BEPS project. In the portion of that section that deals with systemic issues within our legal and tax environment, it is explained that MNE management personnel are often personally motivated to minimize effective tax rates due to their equity-based compensation plans. With an individual's compensation being based wholly or in part on share price, there is a conflict-of-interest that can potentially cause a corporate executive to perhaps inappropriately push the envelope on aggressive tax structuring. A professional must be sensitive to such situations and not allow an overeager corporate executive's enthusiasm for tax reduction to cloud the professional's judgment.

The Ernst & Young "2011-2012 Tax Risk and Controversy Survey" provides some excellent closing thoughts to this Section B.

> Rarely have tax function leaders, tax administrators and tax policy-makers been in such agreement: a convergence of trends has created the ripest environment for tax controversy in years. Audits are more frequent and aggressive, and thus more costly to defend or litigate; assessments and penalties have now entered the realm of billions of dollars; and companies face unprecedented scrutiny and reporting of their tax affairs by advocacy groups and the news media, often hurting brand reputation and -- in the worst cases -- shareholder value, even when such coverage is unwarranted or inaccurate.

Students are encouraged to look closer at this survey, which is included in the course website. It may also be found at: http://www.ey.com/GL/en/Services/Tax/2011-12-Tax-risk-and-controversy-survey. The most recent 2014 survey is available at: http://www.ey.com/Publication/vwLUAssets/EY-2014-tax-risk-and-controversy-survey-highlights/$FILE/EY-2014-tax-risk-and-controversy-survey-highlights.pdf. See also the "Taxand

Global Survey 2015", which includes a finding that "77% of respondents agreed that the exposure of corporate tax planning, if perceived as 'aggressive', has a detrimental impact on reputation". See http://www.taxand.com/taxands-take/thought-leadership/taxand-global-survey-2015.

C. Jurisdiction

Jurisdiction is of course a very broad and technical subject. However, for our purposes and from a very practical perspective, a country's jurisdiction is merely the area within which it can effectively enforce its laws.

Although not necessarily contemplated by drafters of tax law around the world, jurisdiction effectively governs the overall structure of tax laws worldwide. The practical ability to enforce laws against a country's residents and non-residents is integral and has been a major reason why countries worldwide over the past century have structured their tax laws along generally similar lines.

While many countries have some "territorial" aspects within their tax laws, many countries tax their residents, over whom they have full jurisdiction, on their "worldwide" income. "Worldwide" and "territoriality" as bases of taxation and methods of eliminating double-taxation are covered later in this paper.

As for the taxation of non-residents, including non-resident entities owned by residents, most countries apply the following:

- Direct Taxes versus Withholding Taxes

  Where a taxpayer established or resident in country A has sufficient connection and activity within country B (typically a place of business and regular business activity through employees or agents, often termed a "permanent establishment"), country B will usually attempt to directly tax the taxpayer's profit (i.e., net income) earned within country B. This reflects the fact that country B will have sufficient information in such cases to reasonably calculate the taxpayer's profit (gross income less expenses). It also reflects the fact that country B can readily enforce its tax laws directly on the taxpayer since the taxpayer (despite its establishment or residency in another country) will have a place of business within country B along with significant local assets and personnel.

  While country B's domestic law and applicable tax treaties will most typically provide for taxation based on a taxpayer's actual profit, some countries (most often developing countries) will apply "presumptive" taxation. This means that a formula-based estimate of profit or a negotiated level of profit will be the basis for tax rather than an actual computation of profit. See further discussion of this subject in Section M below in the section headed "Differences between branch and subsidiary taxation".

In the absence of a permanent establishment, country B will most typically not tax business income from the sale of goods or the performance of services. In the words of the OECD Commentary, "until an enterprise of one State sets up a permanent establishment in another State, it should not be regarded as participating in the economic life of that State to such an extent that it comes within the taxing jurisdiction of that other State." (Paragraph 42.11 of the Commentary under Article 5 of the OECD Model Tax Convention. Also, see later in this paper in the section on the BEPS project some brief comments on The Digital Economy (Action 1), which encourage countries desiring greater taxing rights on digital economy income to enact provisions in their domestic law that would tax income now generally protected from taxation due to the lack of any permanent establishment.)

While having a permanent establishment normally means that a non-resident maintains a place of business and conducts regular business activity, some countries (most typically developing countries) will deem a permanent establishment to exist when a non-resident having no place of business of its own within the country sends personnel to perform services within the country's borders. This approach, which is reflected in some tax treaties, carries various administrative and compliance difficulties for both tax authorities and taxpayers. (For background on this issue and certain 2008 changes to the Commentary on Article 5 of the OECD Model Tax Convention, see the OECD public discussion draft, "The Tax Treaty Treatment of Services: Proposed Commentary Changes", dated 8 December 2006 and Paragraphs 42.11*ff* of the OECD Commentary on Article 5 of the OECD Model Tax Convention. See also Article 3 of the Protocol signed 21 September 2007 amending the 1980 treaty between the US and Canada. This Protocol has added to the treaty a "service permanent establishment" provision in Paragraph 9 of Article V.)

Where a country A taxpayer has less contact with country B so that there is no permanent establishment, country B will generally attempt to enforce its tax laws through a withholding regime. Country B therefore requires withholding of tax when a country B person pays income to the country A taxpayer. The withholding tax is usually, but not always, a percentage of the amount of gross income (most often revenue unreduced by any related expenses). This reflects the facts that information on the expenses of the country A taxpayer is not readily available (making it difficult to calculate net income) and that it will likely be difficult for country B to legally force the non-resident taxpayer to make tax payments since that taxpayer will have few assets within the practical reach of the country B courts. Because of this latter fact, country B imposes the withholding obligation on its own residents and any non-residents that maintain permanent establishments in country B, against whom enforcement is easy.

Withholding tax is generally only imposed on certain types of payments, e.g. compensation, certain service fees, dividends, interest, royalties, and rents. Business income from the purchase and sale of goods, and often from the performance of services as well, is typically not taxed in the absence of a permanent establishment. Note that country B import duties and import VAT will apply even if there is no country B taxation of the country A taxpayer's business income. Also, in most cases, these import

duties and import VAT will be legal obligations of the country B customer rather than the country A seller, unless that latter party is the importer of the goods into country B. Occasionally, countries will require withholding from the purchase price paid for land or other capital assets sold by an overseas taxpayer to a resident. The closely watched Vodafone case involving the application of withholding tax on a sale of shares between two non-residents was initially decided in the taxpayer's favor by the Indian Supreme Court in January 2012, but is still ongoing at the end of 2016. The Chinese authorities have also been aggressively pursuing some offshore sales. See further discussion in Section Q below.

- Attack the Shareholders of Foreign Subsidiaries

  A number of countries have recognized that considerable business activities of their resident taxpayers are conducted through foreign subsidiaries of those resident taxpayers. Because such subsidiaries are outside the jurisdiction of the country of the parent company, a number of countries have enacted "controlled foreign corporation" rules (often abbreviated as "CFC" and sometimes labeled "anti-tax-haven provisions"). These rules tax the parent (over which its country of residence does have jurisdiction) on the calculated profits from certain defined activities or categories of income of the foreign subsidiaries. Usually, any such income that is taxed in the hands of the parent is treated in the same manner as an actual taxable dividend from the foreign subsidiary would be treated. In Asia, for example, Australia, Japan, Korea and China have enacted CFC rules. Where a country maintains a hybrid-territorial system that would normally exempt dividends from tax, that exemption would not apply to any CFC income that is required to be recognized. Note that one of the OECD BEPS Action items is the strengthening of CFC rules.

At the beginning of this section, it was noted that drafters of tax law around the world did not necessary contemplate jurisdiction a great deal when tax laws were first being enacted. Regarding the US, it is interesting to note what Stanley Surrey said back in 1958 about the US not taxing the non-US source income of non-US corporations owned wholly or partly by US persons (e.g. foreign subsidiaries of US parents).

> These jurisdictional rules, in the United States and probably elsewhere, developed almost intuitively without any intensive consideration of the situation. In fact, the combination of initially low tax rates and the small volume of international activities meant there was no situation to consider. But the rules were there, and as rates and international activities increased, the rules formed the foundation of the tax structure in this area and shaped the consequent tax treatment. [Stanley Surrey, "The United States Taxation of Foreign Income", 1 J.L. & Econ. 72 (1958), as quoted by Jasper L. Cummings, Jr. in "Consolidating Foreign Affiliates", 11 Fla. Tax. Rev. 116 (2011).]

D. Sanctity of the separate legal entity

Some countries attempt to apply "substance" rules that can, on occasion, ignore legal entity lines and contractual labels. Some countries allow group loss relief or the consolidation of tax accounts of some related companies. This can have the effect of ignoring to some extent the legal entity lines that separate the various company members in a group of related companies. Despite these "substance", group relief, and consolidation rules, most analysis of taxation issues must be done on a taxpayer-by-taxpayer basis, which means for non-human taxpayers, a legal-entity-by-legal-entity basis. Each company, partnership, trust, and individual must be separately considered and contracts must be carefully reviewed as to which individual or legal person is affected. (Note that around the world there are some number of legal forms of organization that might not be legal-entities under local law, but which are treated as separate taxpayers under one or more countries' tax laws. The discussion in this section equally applies to such forms of organization. See further discussion in Section J below.)

As a brief example of this legal-entity-by-legal-entity analysis, assume a two-company group where one company manufactures a product and the second company sells it to customers. The first company (X) owns the manufacturing facility, buys the raw materials, and employs the production personnel. The second company (Y) employs sales personnel, rents office and display space, and contracts with customers.

Because X has produced the products with Y selling them, and in the absence of other information, it is natural to assume that X must have sold the manufactured products to Y. If this is the case, then there must be appropriate documentation of this between the two companies, i.e. a sales contract, invoices, etc. However, this is not the only possible contractual situation. Assuming the jurisdiction in which the companies are located allows an agent to act on behalf of an undisclosed principal or provides for a commissionaire arrangement ("commissionaire" is described in Section M), Y could legally be making sales on behalf of and for the account of X. In this case, there would need to be an appropriate agency or commissionaire agreement between the two companies.

The point of this brief example is that in analyzing the taxation of each of the two companies, it is necessary to look at each company separately and determine its character from all of its relationships with other parties. For example, if products are being sold from X to Y, then Y is earning gross profit from its resale of the products to its customers. On the other hand, if Y is acting as an agent or commissionaire, then it is earning service income. As will be seen later, the distinction of the type of income being earned can make significant differences in how such income is taxed in cross-border situations.

Another point of this example involves the timing of income recognition by X. If products are being sold by X to Y, then that date of sale defines the point when X must recognize income. On the other hand, if Y is acting as an agent or commissionaire, then the recognition of X's sales income only occurs when sales are made to third parties, which will typically be at a later date.

Within the US, large affiliated groups often operate through many domestic subsidiaries. Due to consolidated reporting for both financial and federal tax purposes, such groups can on occasion be somewhat sloppy in their attention to documenting their internal corporate relationships and intra-group transactions. It is particularly important that such groups, whether large or small, not act similarly when forming and operating subsidiaries, affiliates, or branches outside the US.

It is appropriate at this point to briefly mention the US "check-the-box" rules, which are perhaps unique around the world. If the student has not already done so, it is strongly suggested that he or she read, at a minimum, Treas. Reg. §§301.7701-2(a), -2(b)(1) - (8), -3(a), and -3(b)(1) – (2). These provisions will often allow an option regarding how a particular form of organization (whether established under US law, state law, or the law of some non-US jurisdiction) will be characterized for US federal income tax purposes.

In brief, a form of organization that has more than one owner might be able to be characterized for US federal income tax purposes as either a corporation or as a partnership. Being characterized as a corporation means that the organization will be treated for US federal income tax purposes as a separate taxpayer. By contrast, being characterized as a partnership means that the organization is not itself subject to tax; rather, its owners are the taxable persons and are treated as partners who are subject to the partnership tax rules specified in Subchapter K of the US Internal Revenue Code.

In contrast to an organization having two or more owners, where there is only one owner, the organization might be able to be characterized as either a corporation or a "disregarded entity". In applying the US federal income tax rules for a disregarded entity, the separate legal existence of the organization is ignored and its assets and activities are treated as being directly owned/conducted by the single owner.

The particular point to make here in relation to this "sanctity of the separate legal entity" subject is that non-intuitive situations can sometimes arise when the US "check-the-box" rules are applied to non-US entities. Say that a US multinational enterprise (MNE) forms a new subsidiary in China using the limited liability company form of organization available under the Chinese Companies Law and elects under Treas. Reg. §301.7701-3 to treat that new subsidiary as a disregarded entity for US tax purposes. That election means that when the US MNE prepares its US corporate tax filings, it will "pretend" that there is no subsidiary in China and that it is operating through a branch in China. As such, it will directly recognize as its own income and expenses the revenues and costs incurred by the entity in China. It will also, for example, calculate depreciation expense as if it directly owned the subsidiary's fixed assets.

This "pretend" treatment is solely for US federal income tax reporting purposes. As such, there still is a real separate legal entity owning assets and conducting business within China. That entity, being real, is respected for all Chinese legal and tax purposes as well as by any other relevant jurisdiction, including even the US for all purposes other than federal income taxation.

How will the US and Chinese tax authorities each view this Chinese subsidiary from a transfer pricing perspective? Say that the subsidiary sells to a related party in a third country that maintains income tax treaties with both China and the US. Which treaty's dispute resolution

(competent authority) procedures will apply? Or will both potentially apply? Say that the subsidiary borrows money from a lender in a third country. Will the US have any ability to require the US MNE to withholding tax from interest payments made to that lender? The questions that can arise from this ignoring by the US of the separate legal entity status are endless.

E. Consolidated financial statements vs. separate entity taxation

Many multinational companies are publicly held with their share prices and market capitalization affected importantly by the level of their financial statement net after tax earnings. As such, since the level of income tax expense under accounting rules directly affects net after tax earnings, public companies are normally interested in planning that will reduce their tax expense and increase their earnings. Of even greater concern, though, are unexpected increases in their financial statement tax expense that decrease their earnings, and therefore their share price and market capitalization.

An unexpectedly high effective tax rate on a consolidated financial statement can arise from having profits and losses in different group companies. The profits and losses may offset on the consolidated financial statement income statement but, as discussed in the previous section, without some form of group tax loss relief or group tax consolidation, the separate company profits are subject fully to taxation with no benefit being realized for the losses in other group companies.

A very simple example to illustrate:

	Parent **Country A**	**Subsidiary 1** **Country B**	**Subsidiary 2** **Country C**	**Subsidiary 3** **Country C**	**Financial Statement Consoli-dation**
Financial Stmt Pre-Tax Income/(Loss)	$50	($25)	$100	($25)	$100
Tax Rate	35%	25%	35%	35%	N/A
Tax Expense	$17.5	$0	$35	$0	$52.5
After Tax Income					$47.5
Effective Tax Rate					52.5%

Note from the above example that there can be two situations where losses do not offset gains. First, as shown by the two subsidiaries in country C, the lack of local consolidation or other loss relief results in country C tax being calculated based on 100 and not based on the combined income of 75 earned within country C. Second, the country B loss of $25 in Subsidiary 1 does

not offset at all either the $50 of income in the Parent in country A or the $100 of income in Subsidiary 2 in country C.

This first situation is not unusual. Many countries do not maintain any domestic tax consolidation or other intra-group loss relief or intra-group contribution rules. Under loss relief, a group member incurring a loss may surrender that loss to another group member that reduces its taxable income by the amount of the loss. Intra-group contribution rules achieve loss sharing by allowing one group member to make a tax deductible contribution to another group member, with that contribution being taxable income to the recipient.

Operations in multi-corporate form within a single country must be structured, to the extent possible, to avoid such problems. The single country situation occurs very often in multi-national groups due a number of reasons. One common reason is that autonomous divisions within a multi-national group often act without regard to what other divisions are doing in the same country. As such, a separate company is often formed for each division's activities. Multiple corporations in one country can also arise from mergers or acquisitions where new subsidiaries in that country are directly or indirectly acquired by a group already having one or more subsidiaries in that country.

The second situation described above is very common. Home country tax consolidation or other such rules normally will not allow losses in overseas subsidiaries to offset profits of the group's domestic members.

Planning to overcome the detrimental effects of these two situations (i.e. the inability to offset for tax purposes profits and losses in different group members) is often an important focus of international tax planning.

F. Universality of laws and legal concepts

While the detailed rules vary, the basic structure and conceptual frameworks of virtually all countries' taxation systems are the same. The same may be said for many other areas of the law. As such, it is possible for an international tax planner to intelligently review a transaction in any country. If he is good at what he does, he is able to review and understand the facts of the business activities or transaction, identify issues, and then work with local taxation advisors for the particular country(ies) concerned to arrive at specific answers and recommendations.

In the tax area, for example, there is an almost universal structure of direct taxation on non-residents (individuals or corporations) that have a certain minimum level of contact with a country (usually termed a "permanent establishment"). Where that minimum level of contact is not met, then a withholding tax regime applies. (See comments under Jurisdiction above.)

More generally, many countries have, conceptually, very similar laws and legal structures in areas such as companies law, types of corporations and partnerships, competition law, contract rights, labor law, intellectual property law, etc.

Though the basic structure and conceptual frameworks may be similar, cultural and other differences can significantly impact the interpretation and practical implementation of law in each country. It is particularly important for the international tax advisor to gain an understanding of these differences and to work closely with local professional advisors who know the local legal environment and practices. See "The environment" in Section A above.

G. Break up the whole into parts

A particularly important technique of international tax planning is to break up a major transaction or business activity into its component parts. By doing so, some parts may be taxed in some more favorable manner or perhaps not taxed at all in a particular jurisdiction.

Engineering and construction project

For example, assume a major engineering and construction "turnkey" contract for the design and construction of a major chemical processing facility. The contractor is based in country A while the location of the project and the customer is in country B. As explained in the example above under "Why is international taxation important", without planning, country B's taxing authorities will often attempt to tax the contractor's entire net income from the contract at country B's regular tax rate on net income. With planning, the contractor's activities on the contract and the net income there from are broken up among some number of separate legal entities. Some of these entities will be taxed by country B while others may be taxed either only in country A or only in some third country. Further, some income that is taxed in country B may be taxed at lower rates than the normal tax rate on net income.

This engineering and construction project can be broken up into a number of identifiable activities including:

- Onshore construction ("onshore" refers to activities occurring in country B while "offshore" refers to activities occurring in country A or in some third country other than country B),

- Onshore construction supervision,

- Onshore engineering, design, and drafting (typically there will be both onshore and offshore components, but the bulk will often be offshore),

- Offshore engineering, design, and drafting,

- Technology and other intangibles (generally provided from offshore),

- Financing (could be from onshore or offshore or both plus it may be possible to separate out certain financial advising and consulting functions that could be valued and treated separately from the financing itself),

- Equipment procurement (often conducted offshore but there may be significant onshore procurement activities in some cases), and

- Personnel procurement (often conducted offshore but there may be significant onshore procurement activities in some cases).

Each different activity can be placed into one or more separate companies to allow for differing taxation (or no taxation) of the activity. As a few examples:

- Offshore services can be in a country A company that itself has no activities or place of business in country B. Typically, such a company would earn income from its services free of country B tax.

- The sale of offshore-sourced construction material and equipment can be made by a country A company with no activity or place of business in country B. As long as the customer or another company acts as importer of record and takes title to the construction material and equipment at the country B border or before, the country A seller's income from such sales is normally not taxable by country B.

In addition to the issue of separating activities, it can also be possible to contract with a client in a manner that helps and facilitates tax planning. Accordingly, in this example of an engineering and construction contract, instead of having only one contract with the customer that covers the entire project, it may be possible to break up the one contract into two or more separate contracts. One contract might cover solely the onshore construction and certain other onshore activities. Another contract might pay for offshore services such as engineering, design, and drafting. A further contract might involve a purchase or license of intellectual property that might relate to some special nature of the project. Finally, another contract might cover the purchase and importation by the customer of certain construction materials and equipment.

An important issue in separating contracts is whether the customer will agree to a break-up of the single contract into multiple contracts. Where a "turnkey" contract is intended by the parties, there may need to be certain completion guarantees or other contractual mechanisms to provide the customer with comfort equivalent to what it would have had had there been a simple "turnkey" contract. Note that in a "turnkey" contract, the constructed facility is only taken over by the buyer when the facility is completed and working. As such, a "turnkey" contract can be seen as being close, economically, to the purchase/sale of a piece of property. On the other hand, the several broken up contracts are for services, for intangibles, for various components of the facility, and for the purchase of equipment. While risk of this is normally low, planning of this nature can potentially be challenged by local tax authorities under anti-avoidance rules and "substance versus form" concepts if they believe that the several transactions should be re-characterized and viewed as one combined arrangement for the application of tax law rather than as a number of separate contracts. See discussion on this in Section Q below.

Manufacture and sale of products

Where a group is manufacturing a product in one country and selling it into one or more other countries, the manufacturing function and the selling function may be separated into different legal entities. Further, the selling function can be further separated through the use of a distributor, agent or commissionaire while the manufacturing function can be separated by the use of contract manufacturers or tolling. In either case, the company that acts as the distributor, agent, commissionaire or the contract manufacturer or tolling party can be related (i.e. commonly owned or controlled).

It is possible to place in different group companies differing functions and levels of risk so as to control which entities should economically earn relatively more or less profits. For example, the company that will hold inventory will normally carry a risk of inventory obsolescence. However, this risk could be contractually transferred to another related company. Or, a company might sell directly to customers, but a different related company will carry the credit risk of the customers' receivables. Companies in a group that carry relatively more business or credit risk should normally earn a greater proportion of any aggregate profit earned by the related companies involved in the transactions. This is basic to the "supply chain" planning that many multi-nationals are now using.

H. Classes of income and source

Why relevant

Source is the location where income is treated as being earned. Note that it is "gross income", and not "net income", that source rules focus on. Where net income must be determined since net income is the base for a tax being imposed, different rules on expense allocation will apply to calculate that net income tax base.

Source is important for a number of reasons.

- Typically a country does not tax a non-resident individual or company unless that person has income sourced in that country. (See Section K below regarding "residency and basis of taxation".)

- Source is typically used in foreign tax credit limitation calculations. (See the foreign tax credit portion of Section L below regarding "elimination of double-taxation".)

- A number of countries have some form of territorial basis for taxing not only non-residents but for taxing their residents as well. For these countries, the source of income may be one factor that defines their residents' tax base. (See Section K below regarding "residency and basis of taxation".)

Source conflicts

Different criteria for determining the source of income apply to the various types of income. As is perhaps understandable, countries are not uniform on which criterion is used for each type of income. Thus, as shown below, there may be more than one possible criterion for a type of income. To determine the source of any particular item of income, the domestic tax laws of the country concerned or the rule in the relevant tax treaty would have to be checked.

With each country within its domestic tax law and each treaty having its own sourcing rule for a particular type of income, there is of course room for conflicts where a specific item of cross-border income in the hands of a taxpayer is relevant to two or more countries. Such conflicts can potentially create double-taxation or no taxation in either country.

As a simple example of a source conflict, consider a company performing technical services within its country of residence for an overseas client. Typically, such services would be taxed in the home country as domestic source income since the services are performed therein. However, the domestic law of the client's country may potentially take one of several positions. On the one hand, the client country's domestic law may source fees for technical services in the country where the services are performed…in which case there is no conflict on source between the two countries. On the other hand, it may source the technical services fees based on the residency of the payer or, alternatively, classify the fees as royalty with the same result on source. And because of this sourcing rule, the client country's domestic law may impose a withholding tax on the gross income, which in the case of a technical service fee or royalty, is typically the total amount of the payment. Where such a conflict arises, the home country would typically not provide any foreign tax credit relief or any territorial exemption since no foreign source income has been earned from its perspective. This creates unrelieved double-taxation.

Tax treaties will typically reflect two countries' agreement on both (i) the definitions of some classes of income and (ii) the specific source rules applicable to each class. For example, there will typically be treaty provisions defining the classes of dividends, interest and royalties and giving the source rules applicable to each.

Say that a lender and a borrower from countries A and B, respectively, provide in their loan agreement that under certain circumstances the total interest paid will include 10% of the borrower's profits. A tax treaty between A and B will typically provide definitions of dividends and interest so that both countries will treat this equity component of the interest calculation in the same manner.

Identifying what payments are royalties as opposed to business profits or capital gain has been particularly challenging given the advances over the past few decades in technology along with the expanding types of business transactions applicable to intellectual property. Recent developments reflecting the changing environment include the 2008 amendments to the OECD Commentary on Article 12 of the OECD Model Tax Convention. See the OECD Commentary under Article 12 as well as the OECD public discussion draft "Draft Contents of the 2008 Update to the Model Tax Convention", 21 April 2008, pages 11*ff*. Finally, see Treas. Reg. §1.861-18.

Despite the much needed agreement and clarifications that tax treaties provide, since they are normally broadly written and leave many details to be determined under the domestic laws of each country, there can still be conflicts in how these domestic laws treat various items or allocate expenses against various classes of income. Such conflicts can result in double-taxation or no taxation on particular items of income. Examples of this include:

- Treatment of interest on a loan made by a partner to a partnership. One country may treat such interest as actual interest and apply the treaty's interest sourcing rules while the other country treats it as a special allocation of partnership income and therefore sources the amount based on the character of the income earned by the partnership (e.g. business income) and the treaty sourcing rules applicable thereto.

- Treatment of payments made under a "purchase" that is contractually structured as a lease. Countries have varying approaches to the treatment of economically purchased assets that are documented as leases. As such, one country may treat the transaction as a true lease while the other treats it as a sale and purchase. As a result of the difference, one country may treat the full amount of each lease payment as rental while the other country treats only a small portion of each payment as interest, the remainder being the payment of the purchase price. Not only can different sourcing arise from this varying treatment, but significant timing and taxability differences can arise as well. For example, if the country of the lessee treats the transaction as a purchase and the seller maintains a permanent establishment in that country, then the full gross profit on sale may be taxable in that country upon the signing of the lease contract and/or delivery of the asset with only the interest element being recognized over the following lease term. If the country of residence of the lessor taxes the lessor on a worldwide basis and treats the transaction as a true lease, then likely the lessor's entire income will be recognized ratably over the lease term. Such a situation can create significant unused foreign tax credits for the lessor when his country of residence does not allow flexible carryback and carryforward of unused credits.

  While the above paragraph was written from the perspective of potential for double-taxation and unused foreign tax credits, a very significant financial industry has developed over the past thirty or forty years that has focused on cross-border leasing (often leveraged with significant debt) that has specifically utilized such varying treatments as the basis for tax advantages. The result has been an above-market return for passive investors acting as the lessors and an effective low cost of financing for asset purchasers such as airlines purchasing new aircraft, film companies producing movies, and other big-ticket purchasers. As a specific example of such structured leasing, for many years Japanese investors financed many Australian and American aircraft as well as American film productions.

  In very brief terms, the way this works is as follows. The country of the lessor treats the lease contract as a true lease. As such, the lessor retains the asset on its balance sheet and claims annual depreciation charges, which may in some countries be computed on an accelerated basis. Further, the lessor's rental income is recognized over the term of the lease. The net result of this treatment is that a lessor may have losses in the early

years (depreciation in excess of rental income) and income in later years (rental income in excess of depreciation). Where the lessor can utilize the early years' losses against income from other sources, then there is a time-value-of-money benefit.

While this goes on in the country of the lessor, the country of the lessee characterizes the lease contract for tax purposes as a sale and purchase agreement with deferred payments. As such, the lessee places the asset on its balance sheet and claims depreciation, as above, often on an accelerated basis. The "rental payments" made by the lessee to the lessor are broken into two components: (i) payment of purchase price, and (ii) interest on deferred purchase price payments. With the lessor not maintaining any permanent establishment in the lessee country, there will typically be no taxation on any gross profit from the "sale" of the leased property and only interest withholding tax on just the interest component portion of the lease payments.

- Definition of real property. Treaties typically include an article specifying that real property may be taxed by the country in which the real property is situated. As definitions of real property differ amongst countries, conflicts can potentially arise where, for example, an item is deemed real property by the country in which the property is physically situated but is deemed personal property in the country of residence of the taxpayer owning the property.

- Apportionment of expenses against income of a permanent establishment. The host country of a permanent establishment and the country of residence of the taxpayer may each have different domestic law rules on allocating expenses against the income of the permanent establishment. Most typically, some degree of double-taxation can arise where the host country domestic law does not allow allocation of certain central office expenses (e.g. management salaries, home office occupancy costs, research and development costs, etc.) or the deduction of various indirect costs such as interest. As a result, the taxable profit in the host country can be significantly higher than the taxable profit on the permanent establishment's income as calculated by the country of residence. For a country that exempts from taxation the income of foreign branches, the amount exempted will be less than the taxable profit in the host country. For a country applying a foreign tax credit system (such as the US), the lower foreign source taxable income in the foreign tax credit limitation calculation can result in unused foreign tax credits. (Note: In addition to the differences in the categories of expenses that can be allocated, the bases on which the allocations are to be made for each category may differ. For example, one country might allocate certain expenses based on the sales generated by each branch while another country might allocate those same expenses based on the net assets of each branch.)

Categories of income

From several of the above examples it will be seen that source rules, by their nature, are applied to categories of income. Specifically, the first three examples involved, respectively, interest on loan versus allocation of partnership business income, purchase price and interest payments versus lease payments, and income from real property versus personal property. As

a result of this category nature, any specific item of income must first be placed into one of a limited number of defined categories before the source rules can be applied to it. The domestic law of each country, of course, defines these categories, which can be modified in tax treaties. While most countries have followed a relatively fixed pattern of categories (see below bullet points), there can be some variation country-to-country. And there can be variation in tax treaties as well.

Note that in class discussion I will refer to these categories as "boxes". An item of gross income must be placed in only one of a limited number of boxes. With few exceptions, it is not possible to split an item of gross income and place part in one box and the remainder in another. This is a principal point to take away from this discussion.

As a simple example of this point, a well-known issue within domestic US tax law is the characterization of a hybrid security as being alternatively debt or equity. This is normally an all or nothing determination (though the issue is now being studied by the US Treasury and the IRS). If the hybrid security is deemed to be debt, then payments under the instrument will be interest or principal repayment. If deemed to be equity, then payments will be dividends, return of capital, or capital gain. There is normally no ability to break up the security into its economic pieces and treat each piece separately.

As indicated by this example, this "only one box" issue is not only a cross-border issue. It's also how domestic transactions must be analyzed when determining taxation. And there can be plenty of differences of opinion between taxpayers and tax authorities regarding the category in which a particular item of income falls.

For any student who likes computer games and wants to scan a somewhat ad nauseum discussion of the possible classifications of income earned from virtual currency, see "Virtual Currency in Virtual Economies: Income Characterization Issues for Social Media Companies" by James Carr, Jason Hoerner, and Carlos Kaplan, 2011 WTD 224-18, 21 November 2011.

Typical categories of income and bases for identifying source

To illustrate the diversity of source criteria that exist, a listing of typical categories ("boxes") of gross income and common source criteria for each follows:

- Gross profit from sales of tangible products in the ordinary course of a trade or business

    - The location where the business is carried on, usually through an office or other fixed place of business

    - The location of the product when the title of ownership passes from the seller to the buyer

    - The location of order acceptance

    - The location where the sales contract is signed

- The location where various functions important to the selling process take place such as negotiations, holding of inventory, signing of contract, etc.

- Capital gain (usually defined as gain from the sale of real estate, securities, intangible property, or any asset other than inventory sold in the regular course of business)

  - The location of the real property where such is the subject of the sale

  - The country of residence of the seller

  - The country of registration of the securities being sold

  - The location of the property being sold

  - The location of the business where business assets (including goodwill) are sold

  - The location of effective management where ships or aircraft are sold

  - The location where rights are exercisable or used where certain intangible assets are sold

  - The location where various functions important to the selling process take place such as negotiations, signing of contract, etc.

- Services

  - The location where the services are performed

  - The residence of the payer (particularly in the case of technical service fees)

  - The location of the business performing the services

- Employment

  - The location where the employment services are performed

  - The residence of the payer (usually the employer)

  - The residence of the employee

  - The location where employment compensation is received

- Royalty and rental

  - The location where the property being licensed or rented is used (always this location if the property being rented is real estate) (Note that location of use is not always clear for personal property. Different countries may take varying positions particularly for software transactions. For example a computer manufacturer (OEM) pays royalties for the right to commercially exploit (copy, install and sell) an operating system by installing the system on the manufactured computers and then selling them. Is this intangible personal property used where the software is installed, where the OEM is based, or elsewhere, such as where the computer holding the operating system is sold or later used by a buyer?)

  - The residence of the payer of the royalty or rental

  - The residence of the recipient of the royalty or rental, especially if that person is carrying on a business of providing such property from that residence

  - The location of the business that is earning royalties or rentals in its regular course of business (e.g. a branch office outside the country of residence)

  - The location where intangible rights were created (e.g. where invented) or are registered

- Interest

  - The location of use of the loan principal

  - The location where the interest cost is borne (e.g. a branch office outside the country of residence of the debtor)

  - The residence of the payer of the interest

  - The location where the funds are provided by the creditor to the debtor

  - The location where the loan contract is executed

- Dividends

  - The residence of the company paying the dividend (typically the country of incorporation or the location where management and control is exercised—note that a company can have dual residency causing more than one country to claim that dividends paid are sourced therein)

  - Occasionally the location where the company paying the dividend conducts the majority of its business and earns its income out of which the dividends are later paid

- Other gains including financial instrument gains, foreign exchange gains, and hedging gains

    - The country of residence of the seller or alienator

    - The country of the permanent establishment to which the financial instrument, foreign exchange or hedging transaction relates

    - The country of the market through which the gain is realized

    - The location where various functions important to the selling process take place such as negotiations, signing of contract, etc.

    - The location of the currency where foreign exchange is sold

    - The location of the business assets against which a hedge has been placed

I. Timing of recognition of income and deductions

Why timing is important

As you know from domestic US tax planning, taxpayers typically attempt to defer the receipt of income and accelerate the recognition of expenses. This is normally desirable simply due to the time value of money. The present value of a dollar of tax paid later is less than the present value of a dollar of tax paid today. In the international context where some countries may have significant rates of domestic currency inflation, the deferral of any local currency denominated tax liability can reduce very significantly the present value of the tax to be paid.

In the US where net operating losses may be carried forward for many years, there is normally little concern that a loss might expire unutilized. Capital losses, with their five-year carryover period in the US for corporations, are more sensitive to potential expiration. Other countries may have short carryover periods and often have no provision for loss carrybacks. As a result, the timing of income and deductions may be of particular importance in the international context. Accordingly, if a taxpayer is in a loss position and there is a short carryover period for the losses, then the taxpayer has an incentive to accelerate income and defer deductions in order to maximize the use of the loss carryover.

Some countries in their annual budget proposals will regularly raise or lower their tax rates depending on their economy's needs. Depending on the direction of change, either accelerating or deferring taxable income to the extent legally possible may be appropriate.

Cash vs. accrual methods of accounting

Under the cash method of accounting, income and expenses are recognized when cash is received or paid. Some countries have a "constructive receipt" concept under which income,

the receipt of which is delayed by an action of the income recipient, will be recognized at the earliest time that the income was actually available to the recipient. Some number of countries apply the cash method of accounting to individual taxpayers.

Under the accrual method of accounting, income and expenses are generally recognized when there is a legal right to the income or a legal obligation to pay the expense. Under most contractual arrangements, the legal right will only occur when the action (e.g. delivery of goods, performance of service, etc.) has been completed. In some cases, this occurs on a ratable basis (e.g. rental, interest, etc.). Most typically, the accrual method of accounting is required for legal entity taxpayers.

As will be appreciated, where local tax law allows the use of the cash method of accounting, there will generally be greater freedom to plan the timing of income and deductions. However, even in the event of an accrual-based system, there may be an ability to affect the timing of an income or expense item by amending the contract to provide for altered terms (i.e., to change the facts to which the applicable law will be applied). As a simple example, assume that a taxpayer wants to defer income from the performance of certain services that involve the preparation of a written report at the completion of the work. Assume further that the normal approach for pricing the work is a per hour charge. If the two parties are willing to agree a flat fee for the anticipated work instead of a per hour charge, then the contract could be amended to provide for that flat charge with it becoming payable only upon completion and delivery of the report. In this way, under many countries' systems, the accrual of the charges that would be on a ratable basis as hours are worked under the hourly fee approach will be changed to an accrual only upon completion and delivery of the written report. This will have the effect of deferring the service income until the completion date. Needless to say, the reason why this becomes the correct result is that the parties have in fact changed the economics of their agreement. (Note that such planning through the change of contractual terms between two or more parties is extremely easy when the parties are related. When unrelated parties are involved, such planning is still possible, but will require arm's length negotiations between the parties.)

Accrual income recognition

The terms of a sale transaction (in particular, the point in time where ownership passes from the seller to the buyer) can determine the timing of income recognition. Sometimes, such terms are controllable. For example, in a sale transaction, the title may transfer from the seller to the buyer at the point of origin (e.g. when the products are delivered to a common carrier), the point of destination (i.e., upon delivery at the location of the buyer), or at some point in between (e.g. when the products "cross the ship's rail"). It can also occur at some later time such as upon installation of an item of equipment and a demonstration that the equipment is in working order. (Note that while the intent of a change in contract terms may be to accomplish a tax objective, that change may also affect other matters. Thus, for example, a change in the time of title transfer may also affect the date on which the buyer must begin insuring the purchase and which party is legally responsible for the transportation.)

Many countries have long-term contract methods that apply to income from major transactions that last in excess of one year. Such rules sometimes require either pro-rata profit recognition over the period of the contract or full recognition of profit upon completion of the project.

Income from services typically is recognized when the services are performed.

Royalties and rentals are typically recognized as income over the period of use of the property.

Interest typically accrues and is recognized for tax purposes ratably over the accrual period. Note that countries may or may not have rules that treat original issue discount in the same manner as interest.

Exchange gains and losses and income from financial derivatives such as swaps and options most typically are recognized for tax purposes when there is a realization event or the transaction otherwise closes. Some countries, though, allow or require that such gains and losses be recognized on a mark-to-market basis. See Section V for further information on exchange gains and losses.

Translation gains and losses arising from the translation of financial statements from one currency to another may be recognized in each period for which a translation is made or they may be recognized in some other manner such as being deferred until some future event, such as the closing of the branch giving rise to the translation. See Section V for further information on translation gains and losses.

Accrual expense recognition

Expenses for services, royalties, rents, etc. are typically recognized as the item is provided and there is a legal obligation to pay an amount that can be reasonably estimated.

Depreciation and amortization of assets that fall in value over time is typically allowed. The period over which such assets are depreciated or amortized varies considerably by country. In some countries, purchased goodwill is deductible neither immediately nor over its useful life. Further, some countries do not allow any depreciation of the cost of non-industrial buildings.

J. Forms of organization

Types of organizations

From a broad perspective, it is important to be aware of five basic forms of organization:

- Corporation,
- Partnership,
- Limited Partnership,

- Limited Liability Company, and
- Variable Interest Entity

While all five of these are "entities" in a legal sense, as explained further below, the variable interest entity (VIE) is not a specially defined entity under local law. Rather, it can be any one of the other four types, which are normally defined under local law (e.g. companies law, partnership law, LLC law, etc.).

In addition to these five forms, trust vehicles are occasionally used for business or investment.

Throughout the world, there is a wide variety of names and iterations of these types of vehicles. Further, under the laws of the various countries, these forms of organization and their owners are treated in varying ways. For example, a partnership (general or limited) may be treated under taxation law as a taxable entity separate from its partners or it may be treated as a transparent entity with the partners being treated as the owners of their proportionate shares of the partnership's activities and assets. It must be kept well in mind that "form of organization" and "taxpayer" are not synonymous terms.

It should also be understood that the treatment of a particular form of organization for tax purposes is not "universal". For example, say that a partnership organized under country A law is conducting business in country B through an office. Country A might treat the partnership as transparent and treat the partners as the applicable taxpayers. Country B, on the other hand, might treat the partnership as a taxpayer, separate from its partners, and tax the partnership rather than its partners. Such inconsistencies must be carefully analyzed to understand their consequences. Tax treaties have not typically resolved such inconsistencies in treatment, though this is now changing. See, for example, Paragraph 6 of Article 4 of the Japan-US tax treaty. Also, see Article 3 concerning "transparent entities" in the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting released on 24 November 2016.

In the twenty years since the US instituted its "check-the-box" rules in 1997, which were partly in response to the proliferating use of LLCs, this situation of two countries each treating a form of organization in a differing manner has become very common. As such, situations will often be encountered in practice where an LLC or private company, which is formed by a US taxpayer either in the US or in some other country, is treated under US rules as transparent while the other country treats the entity as a taxpayer separate from its owners. See section below regarding "Characterization of foreign entities".

Comparison of corporation and partnership

Corporation	Partnership
- Typically used by larger businesses	- Typically used by smaller businesses
- More complexity in formation and continued existence	- Typically simpler to form and legally maintain
- Incorporated and given legal personality	- Often formed solely by P/S Agreement with no legal personality under governing law
- Governance (Shareholders, Board of Directors, Management)	- Managed by partners
- Less flexible form	- More flexible form (can have partners with differing capital and income interests)
- Limited liability of shareholders	- Unlimited liability of partners
- Free transferability of shares	- No free transferability of ownership interest
	- Agreement of other partners needed to transfer ownership

Limited partnerships

A limited partnership is a partnership that has both limited and unlimited partners. Limited partners will generally only be obligated to pay in their agreed capital contribution.

Limited partnerships have often been used in oil and gas, real estate, and other investments where certain principals who have organized the investment have unlimited liability while the non-active/passive investors' liability is limited to their agreed contributions. As is true generally for partnerships, there is considerable flexibility in the limited partnership form to apportion the income and loss in any way that makes economic sense to the partners.

An increasing number of countries have a "limited liability partnership" format. This is often not a true limited partnership but rather is focused for use by professionals (doctors, attorneys, accountants, engineers, etc.) who must practice in a general partnership format but where local law allows them some limited liability protection from the mal-practice of their partner colleagues. An example of this is the "special general partnership" found within the Chinese Partnership Law.

Limited liability companies

A limited liability company (LLC) is a hybrid of a corporation and a partnership. Its typical characteristics are:

- Fixed by agreement
- No shares; rather members hold units in the LLC
- Units not freely transferable

- Limited liability of all members; only their contribution or the amount of their agreed obligation to contribute is at risk

- Flexible governance structure that could resemble a corporation or partnership

We are seeing LLCs more often in international taxation due to several factors. First, an LLC is a limited liability vehicle that allows greater flexibility to structure ownership and income sharing interests in comparison to a normal corporation. Second, for US investors, there are favorable US tax rules that generally allow an LLC to be treated either as a corporation or as a partnership for US tax computational purposes. This US treatment includes both an LLC formed under the law of one of the US states as well as LLCs and certain similar entities formed under the laws of other countries.

Note in particular that when analyzing the possible use of any LLC that will be treated as transparent in its country of establishment that it is necessary to include a careful review of the manner in which any host or source country will view the LLC. In some situations, it is possible that tax treaty benefits can be lost due to the LLC not being considered a tax resident in its country of establishment. Even where a country does allow the owners of the LLC treaty benefits, there can be practical concerns about applying for and sustaining treaty benefits.

Variable interest entities

A VIE is an investment structure wherein the investor (or investors) exercise control and realize benefits of ownership and risk of loss through contractual means rather than solely through equity ownership. This form of organization has been used extensively in foreign investment into China and other locations where local laws may restrict foreign ownership in certain sectors.

As a simple example of a VIE structure, say that a US parent company (Parent) as part of its business does consulting work in the area of internet security. Say further that it sees an opportunity for providing such consulting to a branch of the Chinese military, but local rules require that such consultation services may be obtained by the military only from a locally controlled Chinese company.

In order to take advantage of this opportunity, a trusted employee of a wholly owned Chinese subsidiary (Sub) of the Parent forms a new Chinese company (VIE) that will contract directly with the Chinese military for the consulting services. Since equity ownership is solely in the hands of the employee, the employee, the VIE, the Sub and the Parent enter into a series of contractual agreements under which the Parent's group acquires all of the economic benefits of the VIE's business and is obligated to provide financial support to the VIE. The Parent's group also controls the voting rights to the VIE through contractual agreements.

While our interest is in recognizing VIE arrangements as a form of organization sometimes used in cross-border investment, there are many accounting rules and significant literature on the subject. The principal focus of these accounting rules is on whether the activities of the VIE are

to be consolidated in the financial statements of the group parent company. Separate from these accounting rules are legal and tax issues such as:

- Whether local laws are being violated through the use of the VIE structure;

- Whether the VIE should be considered under local tax rules and home country tax rules as only a nominee or straw-man acting on behalf of the investor;

- How controlled foreign corporation rules, transfer pricing rules, and other relevant home country rules might or might not apply; and

- Whether there are ethical issues and reputation and other risks that the parent's board of directors and management are adequately facing and evaluating.

For those interested in the US Generally Accepted Accounting Principles applicable to VIEs, see ASC 810-10 in the Accounting Standards Codification, which can be found at www.fasb.org.

Joint ventures

Two or more groups from the same or differing countries will, on occasion, decide to jointly pursue a new business or one-time project that will be conducted predominately outside the home country of one or both of the participants. In such a case, it will be necessary to determine what form of organization will be used as well as in which country the chosen vehicle will be established.

Especially where a new business is being pursued, the joint venture may develop an independent management that is not a mere extension of one of the venturing parties.

The term "joint venture" is a general term that does not signify any one particular type of organization. Typically, a joint venture will take one of three forms.

- Corporation

  Ownership is based on share holdings with clearly set out governance provisions.

- Partnership or LLC

  There is greater flexibility in sharing of profits and losses and in manner of governance.

- Consortium

  Typically, rather than forming a corporation, partnership, LLC or other form of organization available under local law, the principals of a consortium will enter into contractual arrangements that set out how they will work together on some joint project. Normally, a consortium is not able to contract in its own name since there is legally no consortium entity. There may be no sharing of profits and no joint and several liability

toward third parties who contract directly with one or more of the parties. The consortium agreements will set out how the parties will work together toward their common objective and how they will share common expenses. Consortiums are sometimes used in large construction projects.

Typically, a consortium will be ignored by the taxing authorities who will deal with each consortium member directly. On occasion, a consortium will be treated as a partnership.

Characterization of foreign entities

It is of course very common that a taxpayer (individual or entity) that is a resident of one country owns an interest in an entity established under the laws of another country. When determining that taxpayer's home country tax obligation, it is necessary to determine the character of that entity as either a corporation or as a partnership (or as otherwise transparent such as "disregarded entity" status under the US "check-the-box" rules) under the home country tax law. If it is determined to be a corporation, then the taxpayer will typically only recognize income when dividends are paid (ignoring CFC legislation that might apply). If it is determined to be a partnership or otherwise transparent, then the taxpayer will often recognize his share of the income or loss from the entity's activities, irrespective of whether distributions have been made.

Most typically, the home country determination of how to characterize a foreign entity is not based on the local tax treatment in the country of formation. Rather, as a first step, an examination must be made of the legal rights and obligations of the members of the entity under the applicable foreign law. The results of that examination are then treated as "facts". Then, one examines those "facts" in light of home country law and determines how the legal rights and obligations of the members are similar to or different from those of shareholders and partners of home country corporations and partnerships.

On occasion, courts outside the US have examined whether a transparent LLC or limited partnership in the US should be treated as transparent or as a corporation for purposes of that country's tax rules. For example, say that a Japanese investor invests into a US limited partnership that will own real estate. Will that investor be treated as owning a share of the real estate or as owning an interest in a US corporation for Japanese tax purposes? For some discussion of such a situation, see "Foreign Entity Classification in Japan", 80 Tax Notes Int'l 335 (October 26, 2015). For those wanting to study this area in greater detail, a recent UK case is Anson v HMRC [2015] UKSC 44. See also Revenue and Customs Brief 15, available at: https://www.gov.uk/government/publications/revenue-and-customs-brief-15-2015-hmrc-response-to-the-supreme-court-decision-in-george-anson-v-hmrc-2015-uksc-44.

The US "check-the-box" approach under the Internal Revenue Code section 7701 regulations that effectively allow taxpayers their choice is perhaps unique.

K. Residency and basis of taxation

Introductory comments

Most countries use the terms “resident” and “non-resident” to categorize all types of taxpayers including individuals, estates, limited liability companies, corporations, trusts, and other taxpayers including forms of organization such as partnerships that might not be separate legal entities under local law but which are treated as separate taxpayers under local taxation rules. Where a vehicle such as a partnership is not treated as a taxpayer within the country but instead is treated as being transparent, the residency of the vehicle is not normally relevant. Rather, the residency of the partners or other owners who are taxed on the income of the vehicle will be relevant.

How residence is typically determined and the importance and significance of a taxpayer’s status as a resident or non-resident is covered in the sections below.

Determining residency

Various countries typically use the following residency tests, sometimes singly and sometimes in combination, to distinguish the residency of individuals, corporations and other taxpayers.

- Individuals—The typical criteria used by most countries for determining whether an individual is a resident or a non-resident include:

  - 183 Day Test—An individual remaining within the country for 183 days or more in one year will typically be a resident. This test may be applied on a calendar year basis or on the basis of any consecutive period of 365 days.

  - Qualitative Test—An individual whose business and family interests cause him or her to be most closely associated with that country (in contrast to any other country) will be a resident.

- Corporations and Other Non-Individual Taxpayers—The typical criteria used by most countries for determining whether a corporate or other entity is a resident or a non-resident include:

  - Location of Formation—An entity formed in or established under the laws of a country will be a resident of that country.

  - Management and Control—An entity that is managed and controlled, often by the board of directors of the entity, within a country will be resident within that country. Sometimes, a country’s residency rules may look to the day-to-day operational control either instead of or in addition to the control exercised by the entity’s board of directors.

While the above two criteria are what are most commonly found, other factors sometimes seen include:

- Location of Head or Main Office
- Location of Principal Activity(ies)
- Nationality or Residency of Controlling Shareholders and/or Directors

Since each country maintains its own residency rules within its domestic law, there will clearly be situations where the same individual or corporation finds himself or itself to be a resident of more than one country. Such dual-residence may be affected where there is a tax treaty that applies to a particular taxpayer. While treaties often do not alter each country's domestic law definition of resident, they do typically provide "tiebreaker" provisions that will establish of which country a taxpayer is resident for purposes of applying the tax treaty. See Section P and the "intermediary country" portion of Section O herein for further discussion of residency in a treaty context. Also, see Article 4 concerning "dual resident entities" in the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting released on 24 November 2016.

Some countries will apply for certain individual tax purposes a concept of "domicile". An individual's domicile will typically be the country to which the individual plans to return or to remain in for the long term with no intent to go elsewhere. Domicile may be important for certain special taxation statuses or for certain taxation regimes such as estate, inheritance, or gift taxes. The concept may also be applicable to determining property ownership under certain separate or community property laws.

Importance of residency

The residency of an individual, a corporation, or any other type of taxpayer typically affects the manner in which the person is subject to taxation. The three areas where residency is most important are:

- Basis of Taxation—What items of income are taxable to the person in his country of residence or in other countries from which he earns income
- Rate of Taxation
- Applicability of Tax Treaties

Basis of taxation

Most countries apply differing bases of taxation to residents and non-residents. Note that the following discussion under "Typical Bases of Taxation for **Residents**" introduces three terms:

- Pure Worldwide Income Basis,

- Hybrid-Territorial Income Basis, and

- Pure Territorial Income Basis.

These are **not** terms that are commonly used today. Rather, you will typically see just the terms "Worldwide" and "Territorial" used. These three new terms and the discussion of them are intended to give you a better understanding of what in fact exists.

Recently, there has been a somewhat-heated dialogue in the US on how foreign income should be taxed. I believe that the current general use in the media and by some professionals of just these simple "Worldwide" and "Territorial" terms has made it more difficult for participants in this dialogue to actually understand what they're hearing or reading and know what they are talking or writing about.

Note that this section focuses on taxation systems that are actually being used. Over the years, there have been academic discussions, and occasionally political discussions as well, regarding other approaches to either taxing or not taxing the foreign income of a resident-country's taxpayers. For example, there has been discussion of the possibility of implementing a formulary unitary basis of taxation. Such a system would generally ignore legal entity lines and allocate a multinational group's combined net income amongst all countries in which the group operates through a formula approach that could include sales, assets, and employment factors. In the US, another approach is being discussed politically due to its inclusion in the 24 June 2016 House Republican "Blueprint" (available at https://abetterway.speaker.gov/_assets/pdf/ABetterWay-Tax-PolicyPaper.pdf). This approach, termed a "destination-based tax system", bases taxation on the location of consumption of a product or service rather than on the basis of where the product or service is produced. To implement this tax system, "border adjustments" would effectively make exports exempt from the tax and imports fully subject to the tax. In addition to questions of how such a system might economically affect the economy and specific companies, many commentators have raised the question of whether such a system would be legal under World Trade Organization rules.

Again, the following discussion covers taxation systems that are currently being used by countries worldwide.

- Typical Bases of Taxation for **Residents**

  - Pure Worldwide Income Basis

    Some countries impose tax on the worldwide income of their residents (individuals, corporations, and other taxpayers). (The United States requires this for its citizens wherever they may actually reside in the world.) Residents of such countries typically file an income tax return that reports income earned both within the country of residence (domestic source income) and outside the country of residence (foreign source income).

Since the foreign source income may have already been subjected to tax in the country of source, such countries typically provide their residents a foreign tax credit mechanism to alleviate the double-taxation that would otherwise occur. Double-taxation is taxation both by the country of source and the country of residence on the same income.

While the foreign tax credit mechanism is most common, some countries only grant (or allow as an alternative) a deduction for foreign taxes against the taxable income of the resident taxpayer. Note that a deduction against income, in contrast to the foreign tax credit mechanism or the exemption approach mentioned below, only reduces the cost of double-taxation by the value of the deduction, i.e., normally the amount of the deduction multiplied by the marginal tax rate in the country of residence. A deduction therefore cannot normally prevent double-taxation.

The various approaches to eliminate double-taxation are discussed in more detail in Section L.

The US and China are two examples of countries that apply a Pure Worldwide Income Basis. This system is often called a “deferral system” since taxation of the earnings within foreign subsidiaries or other foreign legal entities in which a resident may have invested will not generally be taxed by the country of residence until the resident has received dividends from the foreign subsidiary or other legal entity.

- Hybrid-Territorial Income Basis

  Some countries impose tax on their residents in ways that vary depending on the type of income:

  - Dividends from foreign corporations meeting certain criteria, gains from sales of shares of such foreign corporations, and sometimes income earned through a permanent establishment that the resident maintains in a foreign country

    “Hybrid-Territorial” countries will typically allow an exemption for all or almost all (e.g. 95%) of such income and gains. With this exemption of any resident country taxation, there is no need for any foreign tax credit mechanism or a deduction for foreign taxes on such income. (Some countries will apply, for example, the above mentioned 95% exemption rather than a 100% exemption in order to theoretically offset deductions of the resident dividend recipient that relate to exempt foreign income. This is an administratively easy approach to protecting the domestic tax base of the country of residence. For example, maybe a corporate resident has borrowed money in order to finance its investment in a foreign subsidiary. So, the resident incurs interest expense. In addition, some of the resident’s management personnel spend time overseeing the foreign subsidiary’s operations in the sense that an investor monitors his investments, but those management personnel do not actually conduct any service that benefits the subsidiary in any manner that would allow a service fee to be charged to the subsidiary. This means that the

allocable costs of these management personnel relate to the investment in the foreign subsidiary and not to the resident's business operations. Some countries do not disallow these types of interest and other expenses as deductions even though they relate to an asset (the foreign subsidiary) that will generate exempt dividend income. Rather, through the 95% exemption mechanism, 5% of the dividends the subsidiary eventually pays will be taxable as a means of offsetting the deductions allowed for the interest and other expenses.)

The criteria that must be met for the exemption to apply to dividends or gains from a particular foreign corporation can typically include minimum percentages of ownership by the resident, the nature of the foreign corporation's income and activities, and the level of taxation paid by that foreign corporation on its income. This exemption will sometimes be termed a "participation exemption".

- All domestic income and other foreign source income

  All such income will be subject to normal resident country taxation with a foreign tax credit or deduction mechanism provided to relieve double-taxation. In major developed countries using this "hybrid" system, other foreign source income will typically include foreign source interest and royalty income.

Germany, France, the UK, and Japan are examples of countries that apply a Hybrid-Territorial Income Basis.

- Pure Territorial Income Basis

Only domestic source income is subjected to tax. Foreign source income goes tax-free. A few territorial basis countries have rules that impose a tax on foreign source income upon its remittance into the country of residence. As long as such income remains outside the country of residence, it is not taxed.

Singapore and Hong Kong are examples of jurisdictions that apply a Pure Territorial Income Basis.

Note that the above three bases of taxation for resident taxpayers are typically imposed on a net income basis, i.e. the profits remaining after all expenses have been deducted from gross income. Also, countries might apply a different basis of taxation to each type of taxpayer. Thus, for example, a country might apply the pure worldwide income basis to individual resident taxpayers and the hybrid territorial income basis to corporate resident taxpayers.

In addition to the above three geographical bases of taxation, countries generally apply some form of the classical or imputation systems of taxation to corporations and their shareholders.

- Classical versus Imputation System of Taxation

  Under the classical system of taxation, which many countries employ, corporate profits are effectively taxed twice, one time at the corporate level on its taxable income and a second time at the shareholder level when the corporation's profits are distributed. The US has a traditional classical system, although changes some years ago to the taxation of dividends earned by individual shareholders have reduced the amount of double-taxation.

  In contrast to the classical system, the imputation system partially or wholly eliminates double-taxation of corporate profits. One mechanism employed is that a part or all of the taxes that are paid at the corporate level are credited against the tax liability of the shareholders when they receive dividends. Where a shareholder is an individual, he will typically add together the amount of dividend received and his share of the corporate level tax (his "imputation credit"). The individual tax rate is then applied to this sum to calculate the total tax due. The individual then reduces this total tax due by his imputation credit. If the imputation credit is less than the total tax due, then the individual will pay the excess. Where the imputation credit is more, then some countries allow a full refund to the individual.

  Where there is a chain of corporations so that earnings from one corporation are distributed to a corporate shareholder, various approaches are used to partially or fully prevent there being more than one corporate level tax.

  Generally, only residents may receive the benefit of an imputation credit. As such, with respect to non-resident shareholders, most countries do effectively impose taxes both at the corporate level and the shareholder level. A few countries allow non-residents some imputation credit benefit under tax treaties that they have executed with other countries.

There's one additional taxing format difference worth noting that is used by some number of countries.

- Schedular System of Taxation

  In contrast to including all income and deductions into one pool that results in one taxable income number, the tax laws in some countries define some number of "schedules" into which various types of income and their related expenses fall. Examples of such types could include rents, interest, business income, etc. Effects of this type of system include the ability to apply differing tax rates to different types of income and the limiting of a taxpayer's ability to offset losses in one schedule from offsetting income in another schedule. It can also allow differing taxation or exemption of domestic and foreign source income for each "schedule".

- Typical Bases of Taxation for **Non-Residents**

  - Source of Income Subject to Tax

    Normally, a country will only tax non-residents on their domestically sourced income earned in that country. In some cases, though, where a non-resident conducts an international business from within a country, that country will include in the tax base of the non-resident its income sourced outside the country that is attributable to that business conducted within the country.

    As an example of this, say that a trading company established in country A sets up a trading branch in the US, from which its local employees arrange for international purchase and sale transactions where title to property sold passes outside the US and the property sold will be used, consumed or disposed of outside the US. The US will tax the trading income from any such transaction if there is not an office or other fixed place of business of the company outside the US that materially participates in that transaction.

  - Nature of the Tax Base

    As explained in Section C above regarding jurisdiction, a country will typically tax a non-resident taxpayer on a net income basis if that taxpayer has a permanent establishment in the country. On the other hand, where there is no permanent establishment or where certain types of income have been earned that are not attributable to the permanent establishment, then a flat tax rate on gross income will typically apply. (Note that for sales of property such as real estate or securities, gross income typically means gross receipts less any cost of sale but before any deduction for expenses. For income items like dividends, interest, and royalty, gross income will mean gross receipts since there is normally no cost of sales for such items of income.) Also, where there is no permanent establishment, the tax base will often exclude the non-resident's normal business income such as the sale of inventory or the performance of services in the normal course of business, even if this income in sourced within the country.

    Some countries apply the "force of attraction" principle in defining the tax base and how it is taxed. In brief, where a permanent establishment exists, such countries will require that all domestically sourced income be included in the income of the permanent establishment irrespective of whether that income was, in fact, attributable to the activities of the permanent establishment. The US applies what is sometimes called a modified force of attraction rule that is found in Internal Revenue Code section 864(c)(3). Generally, tax treaties will override such "force of attraction" rules.

The rules regarding the determination of taxable net income or loss will of course vary by country.

- Some countries, such as the US, have a very complex tax law that calculates all items of income and deduction separately in arriving at taxable income or loss. These rules are almost fully independent of either internal management or financial accounting rules. China also follows this approach since the tax law and implementing rules, although relatively brief compared to the tax laws and rules of other countries, provide an independent calculation of taxable income that does not depend on Ministry of Finance financial statement accounting requirements.

- Many other countries have tax laws that do not have a separate calculation of all income and deductions. Rather, they start with either the change in net worth between the beginning and end-of-year balance sheets or the book net income or loss from the year's income statement. They then make some relatively limited adjustments to arrive at taxable income or loss. Such adjustments might include special tax depreciation rules, disallowance of certain contingent liability reserves, incentive provisions such as research and development expenditure deductions, etc.

  The financial statements that are the basis for these taxable income computations are typically prepared under local accounting rules or some other statutorily defined approach, such as, for example, in Japan where Japanese Generally Accepted Accounting Principles (GAAP) are used. Japanese GAAP is based on the Japanese Commercial Code accounting provisions as modified by Japanese SEC and Japanese Society of CPA rules as well as some tax accounting rules. Increasingly, as countries around the world are adopting or modifying their local rules to align with International Financial Reporting Standards (IFRS, also referred to as International Accounting Standards), there will need to be adjustments by each country to account for changes to accounting results so that their tax base is not unintentionally changed. This may add increased complication in some countries.

An important point regarding this distinction of determining the tax base is how publicly listed companies in various countries approach tax planning. Listed companies in the US and other similarly situated countries that have a tax base totally divorced from financial statement treatment typically can take tax positions that affect the income and expenses shown on the tax return but which do not affect these items on the published financial statement results (i.e., no effect on pre-tax financial statement net income). This gives such companies relative freedom in their tax planning. On the other hand, the motivation to tax plan may be very different in countries where the tax base begins with the same accounting as is used for the published financial statements. For example, if it is possible to apply an accounting method that defers income, then likely the financial statement pre-tax net income or loss will be similarly affected as well. Company management may be less than excited by such tax planning that reduces reported earnings.

Another related point involves the characterization of corporate distributions. Again using the US as an example, the detailed tax law provides the concept of earnings and profits for

determining when a distribution will be considered a dividend, return of capital, or capital gain to the recipient. These rules are generally applied independently of the legal characterization of the payment under any applicable local corporate law or companies act. For example, the local law in another country might allow a statutory reduction of capital so that a portion of the capital in a local corporation can be returned to one or more shareholders. When a US shareholder receives his portion of such a capital reduction, he will determine the tax effect in the US of his receipt based on the relevant US rules (i.e., redemption provisions) and the level of earnings and profits within the local corporation as calculated under US tax rules. For local tax purposes, the statutory reduction of capital would normally be recognized as such so that the distribution would likely be treated as a return of capital with no tax effect unless there is a reduction in the local law defined retained earnings, in which case that portion would likely be treated as a dividend distribution subject to withholding tax. Generally, there is no earnings and profits concept in other countries, only accounting retained earnings.

Rate of taxation

A number of countries impose different rates of tax on resident and non-resident taxpayers. While this is by no means uniform, many countries apply graduated rates to their residents, whether individuals, corporations, or other types of taxpayers. (Graduated rates—sometimes termed progressive rates—are tax rates that increase as the level of income rises. An example of graduated rates is where the first 100,000 of income is taxable at 20% and the second 100,000 is taxable at 25% with any amount over 200,000 being taxable at 30%.) Such countries often impose on the permanent establishments of non-resident taxpayers the same graduated rates of tax, or alternatively the highest marginal rate imposed on residents without allowing the lower graduated rates. On the other hand, such countries will typically impose tax at a lower flat rate on other types of income earned by a non-resident (e.g. salaries, interest, dividends, rentals, royalties, etc.).

Note that a number of countries either do not tax capital gains or they tax them at a different rate than is applied to income on normal business transactions (typically termed either “ordinary” or “revenue” transactions). Such rates may be similarly applied to residents and non-residents, or there may be differences in the rates applied. Some countries do not distinguish between capital transactions and revenue transactions such that all such gains and losses are included in the tax base to which the normal tax rates are applied. Both China and Japan apply this approach in calculating the corporate tax base.

Applicability of tax treaties

With just a few exceptions, tax treaties may only be applied to residents of one or both of the countries that are parties to the particular treaty. A typical exception is that certain non-discrimination rules may apply to nationals of a contracting state even though such individuals might not be resident in either country.

Two examples will help explain this point about treaties normally only applying to taxpayers having resident status in one or both countries.

As a first example, a US citizen living and working in the US earns interest income from a Japanese source. This US citizen, as a resident of the US for purposes of applying the treaty, will be able to apply the US/Japan tax treaty to reduce its Japanese interest withholding tax.

As a second example, a Hong Kong company operates through a branch in the US with that branch earning interest income sourced in Japan. Assume that the interest income is effectively connected income taxable in the US as income of the branch. A first question is whether or not the Hong Kong company will be able to apply the US/Japan tax treaty to achieve reduced Japanese withholding tax on the interest. In this case, since the Hong Kong company is not a resident of either the US or Japan, it may not benefit from the terms of the US/Japan tax treaty.

A second question is whether the Hong Kong/Japan treaty would apply. Generally, to be a resident in Hong Kong for purposes of this Hong Kong/Japan treaty, the Hong Kong company would have to have its primary place of management and control located in Hong Kong. This is a question of fact. If the Hong Kong company meets this test and is determined to be resident in Hong Kong, then the interest provisions in the Hong Kong/Japan tax treaty would apply. If the Hong Kong company's primary place of management and control was in fact not in Hong Kong, then the Japanese withholding tax imposed will be that that applies under the Japanese domestic law.

This second example points to the fact that under normal circumstances, the mere presence of a corporation's branch in a host country will not make the corporation resident in that host country. Also, note that where a treaty does apply, the income sourcing rules normally focus on stated criteria that might or might not include the residency status of the payer of the income. Under the interest sourcing rules in both the US/Japan and Hong Kong/Japan tax treaties, interest can potentially be sourced in Japan no matter whether the payer of the interest is a resident or a non-resident Japan.

Ability to control residency

An individual, corporation or other entity may sometimes through planning be able to control its resident or non-resident status with respect to a particular country. This is possible because residency status is normally based on the actual facts surrounding a taxpayer. While facts in the past cannot be changed, the future factual pattern can sometimes be controlled. For example, if in a particular country an individual is only resident if he meets a 183 day test, then planned travel can allow a taxpayer to avoid meeting this test, thereby achieving non-residency. Where a particular country applies a management and control test to determine corporate residency, then it may be possible to arrange for certain of a corporation's management functions to take place outside the country, thereby achieving non-resident status. This sort of planning to achieve the desired residency or non-residency status can be a powerful tool in international tax planning. Through certain US governmental hearings conducted in 2013, it became public knowledge that Apple Inc. had structured certain of its principal foreign subsidiaries to be Irish companies that were not resident in any country. (See http://www.hsgac.senate.gov/subcommittees/investigations/hearings/offshore-profit-shifting-and-the-us-tax-code_-part-2.)

L. Elimination of double-taxation

Introductory comments

Double-taxation means that income is somehow being taxed twice. There are two commonly used terms to describe types of double-taxation.

First, the term juridical double-taxation means that a taxpayer is being taxed by two jurisdictions on the same item of income. A typical example of this is where a US individual, taxable on his worldwide income, has earned salary in another country from several months work in that other country. The salary is taxed by the other country on a source basis and by the US on a residency basis. Both countries are appropriately applying their domestic law. Another typical example is where a corporation resident in one country maintains a branch in another country or has a source of income such as dividends, interest or royalties sourced in that other country. Both countries tax the relevant income under their respective domestic law.

Second, the term economic double-taxation means that two different taxpayers are each being taxed on the same item of income. For a typical example, assume that X and Y are members of a group and that X manufactures a product in country A, its country of residency, that is sold to Y for distribution in country B, which is Y's country of residency. Assume that the tax authorities in country A review the transfer pricing between X and Y and determine that X sold product to Y at artificially low prices. As a result, the country A tax authorities make a transfer pricing adjustment that increases X's taxable income.

In the absence of any agreement by the country B tax authorities to reduce Y's taxable income by the amount of the transfer pricing adjustment, the same income is being taxed once by country A in the hands of X and a second time by country B in the hands of Y.

In this section, we examine mechanisms that reduce or eliminate the effects of juridical double-taxation. As for economic double-taxation such as the above-mentioned transfer pricing adjustment, in the absence of a tax treaty, there may be no mechanism to relieve the double-taxation aside from vigorously pursuing appropriate adjustments in each country through administrative and judicial channels. Where there is a tax treaty, then the competent authority procedure found in most treaties can be used. This procedure, which is set out in Article 25, "Mutual Agreement Procedure", of the OECD Model Tax Convention, provides a mechanism under which a taxpayer can request that the competent authorities of the two relevant countries meet and work out an agreement that will eliminate the double-taxation. While this mechanism can often be successful, there is normally no requirement that the competent authorities must agree on a resolution. They may only agree to disagree, in which case, the double-taxation may not be relieved. Some countries are now working to encourage the use of mandatory arbitration in such disputes to both make the competent authority procedure more efficient and prevent such situations where there would only be an agreement to disagree, thus resulting in no resolution of instances of double taxation. See the later section in this paper on the BEPS project, in particular, the comments on Action Plan item 14, "Making Dispute Resolution Mechanisms More Effective".

As a general rule, countries that tax their residents (and, in some cases, non-residents as well) on income sourced in other countries will have some mechanism to prevent such taxpayers from being taxed twice on the same income (juridical double-taxation). The two typical approaches to preventing such juridical double-taxation are:

- Foreign Income Exclusion
- Foreign Tax Credit

The principle of both approaches is that the country of source is given the first right to tax the income. The other country (i.e., normally the country of residency of the taxpayer) either gives up its right to tax the income or reduces its taxation to the extent of tax imposed by the country of source.

Both approaches can apply to individuals, corporations and non-corporate entities treated as taxpayers (i.e. usually partnerships or LLCs when they are not treated as flow-through vehicles).

Some countries allow their taxpayers a deduction against foreign source income for any foreign taxes paid as an alternative to a credit or an exemption. This, however, does not eliminate double-taxation because the benefit of such a deduction is, at most, only a reduction in resident country tax in the amount of the deduction multiplied by the marginal tax rate in the country of residence.

Foreign income exclusion

As covered in Section K above, some number of countries use a hybrid-territorial income basis in imposing tax on their resident corporate taxpayers. Such countries typically use an income exclusion approach to implement this system.

As an example of long duration, the Netherlands domestic law provides a “participation exemption” under which dividends received on shares in a qualifying participation (a non-Dutch company) as well as capital gains realized on the disposal of the shares will be free of Dutch taxation. Dutch domestic law also has a mechanism (termed a proportional tax exemption) under which there is an exemption for tax that is attributable to income earned by a Dutch resident through a foreign permanent establishment.

The net result of such types of foreign income exclusions is that tax is imposed only by the host country of the non-Dutch company (i.e., the qualifying participation) or permanent establishment as well as by any applicable country of source of the company’s or permanent establishment’s income. The Netherlands does not tax such income. Note that while there may be no company level tax in the Netherlands, there may be a dividend withholding tax imposed on the shareholder of the Dutch company when the Dutch company pays a dividend out of the excluded earnings.

Note that countries that allow a foreign income exclusion normally do not allow that exclusion to apply to all foreign income. Rather, some foreign income is included in the domestic tax base to

which the domestic tax rates are applied. For example, a hybrid-territorial income base country often includes in the taxable income base foreign sourced interest and royalties and sometimes the income of foreign permanent establishments. To the extent that such included foreign income has been subjected to tax by a source or host country, a foreign tax credit is allowed to prevent double-taxation. See the section on the foreign tax credit mechanism immediately below.

Foreign tax credit

In general

Countries that apply a worldwide taxation approach include both domestic and foreign income of their residents in the tax base and apply normal tax rates to calculate tax. And, as noted in the section immediately above, countries that apply the hybrid-territorial income base typically require that some categories of foreign income must be included in the tax base and are not covered by any foreign income exclusion. In the absence of a foreign tax credit mechanism, there would be double-taxation.

Under the foreign tax credit mechanism, the country of residence allows its taxpayers to reduce their domestic tax on foreign source income included in the domestic tax base by the amount of any foreign taxes incurred on such income. Through this mechanism, the taxpayer typically bears on its foreign source income a total tax (residence country tax plus host/source country tax (i.e., the "foreign tax")) that is equal to the higher of (i) the tax of the country of residence and (ii) the foreign tax.

For example, say that a foreign tax has been applied at a 30% rate while the rate of the country of residence is 40%. In such a case, the taxpayer's total tax cost will be 40%. He will pay 30% to the host/source country and 10% to the country of residence. This 10% is the calculate tax at 40% less the 30% foreign tax paid. This reduction is called the "foreign tax credit".

If the rates in the two countries were reversed, then the taxpayer would still have a cost of 40%. However, 40% would be the foreign tax while zero would be paid to the country of residence.

Note that the foreign taxes available for use as foreign tax credits must typically be taxes that are either based on or are measured by income. Thus, taxes based on property values, payroll, gross receipts, etc. as well as value added taxes may not normally be used as foreign tax credits.

Limitation on foreign tax credit

The above example is a very simple case. In "real life", the calculation is rarely so simple. There can be differences between the two countries in their rules on the sourcing of income, the timing of income recognition, what direct expenses are deductible, and which indirect expenses are allocable against foreign source income and the basis on which they may be allocated. There can also be unexpected effects from the movement of exchange rates. Finally, there may be more than one host/source country. In a large multi-national company, there may be fifty or

one hundred or more different host and source countries involved. And, there may be both national and local income-based taxes in many countries.

In order to deal with these complex calculation issues and achieve other goals mentioned below, most countries have implemented in their foreign tax credit systems a foreign tax credit limitation mechanism that typically involves a formula that calculates the maximum amount of foreign tax credit that the country of residence will allow for foreign taxes. This formula is:

$$\text{Maximum Credit} = \text{Resident Country Tax before Credit} \times \frac{\text{Foreign Source Taxable Income}}{\text{Total Taxable Income}}$$

An important purpose behind this formula is to protect the domestic tax base. It accomplishes this by effectively limiting the credit for all foreign taxes to the average effective tax rate in the home country (Resident Country Tax before Credit / Total Taxable Income) as applied to the foreign source taxable income. Thus, the amount of tax remaining payable to the home country can be no lower than this average effective tax rate as applied to domestic source income. This is illustrated in example situations later in this section.

This formula is generally applied on either an overall worldwide basis or a country-by-country basis. For the former, the taxes from all host/source countries are combined in this one formula calculation. This allows the averaging (or as sometimes called, the "cross-crediting") of foreign taxes from high-tax countries and from low-tax countries. Using the above example, there might be equal amounts of foreign source income from two source countries where one has a 50% tax rate and the other a 10% tax rate. The average of 30% would then be the effective foreign tax rate.

Where a country applies the latter approach (country-by-country), the formula is applied multiple times with only a single country's (say country A's) foreign source taxable income placed within the formula. The resulting limitation is then compared to the country A tax liability and the lower of the formula limitation and the country A tax liability is the amount of foreign tax credit allowed.

Foreign tax credit carrybacks and carryforwards

Under this formula mechanism, it can of course happen that the total foreign taxes will exceed the limitation. In such a case, some countries allow carryovers of the unused credits to some number of future years. A few countries also allow a carryback of unused credits to certain earlier years. For example, say that the limitation calculated under the formula for year 1 is 100 but that the total foreign tax paid is 125. There are 25 of unused credits. If in year 2, the calculated limitation is 110 and the foreign taxes for that year are 100, then there is an ability to use 10 of the unused credit carryforward. This allows the taxpayer to reduce his tax payable to the country of residence in year 2 by this additional 10. The remaining unused credit of 15 is carried forward for possible use in year 3.

Timing of recognition of foreign taxes

One other aspect to be aware of is the timing of when foreign taxes are accounted for in the foreign tax credit calculation. Often some income taxes related to a particular year (i.e., imposed on that year's income) will be paid to the relevant government within that year and some will be paid in the following year. For example, say that a taxpayer has a permanent establishment in a particular host country and must file corporate income tax returns in that country. Say further that the taxpayer must pay corporate estimated income taxes for calendar year 2 of 50 in May and another 50 in November of year 2. At the time in April of year 3 when the corporate tax return is filed for year 2, the taxpayer must pay another 30 with respect to its income tax obligation for year 2. In this case, the total tax applicable to year 2 is 130, but 100 was paid in year 2 and 30 was paid in year 3. In some countries of residence, an "accrual" basis is used and the full 130 is accounted for in the foreign tax credit calculation for year 2. On the other hand, in some other countries of residence, a "cash" basis is used under which only 100 (plus any year 1 tax paid in year 2) is used in year 2's foreign tax credit calculation and the additional 30 may only be claimed in year 3.

The indirect foreign tax credit

In order to claim a foreign tax credit, the taxpayer must have directly paid foreign taxes. With two exceptions, it is normally not possible to claim a credit for foreign taxes that have been legally imposed on or otherwise paid by another taxpayer. The legal liability for the tax must rest with the taxpayer and not any other person. The two exceptions are the "indirect foreign tax credit" and any situation where some other person who pays the tax is merely an agent or nominee acting on behalf of the taxpayer. Any case where the taxpayer himself or his agent or nominee has paid the tax is referred to as a "direct foreign tax credit". (Note that in the typical case of a withholding tax on types of income such as dividends, interest, royalty, rentals, salary, etc., the recipient is legally the taxpayer although the recipient does not itself make payment to any government. The payer of the income withholds the tax from the gross amount due to the recipient and pays that amount withheld to the government. This person is not a nominee of the recipient and is often legally acting as a withholding agent for the government. Despite this payment mechanism, these withheld taxes create "direct foreign tax credits" with respect to the recipient of the income.)

The "indirect foreign tax credit" only arises when a taxpayer resident in one country (typically a corporation or a legal entity treated as a corporate taxpayer and hereinafter referred to as "shareholder") owns shares in a corporation or legal entity treated as a corporate taxpayer resident in another country (herein referred to as "investee"). Usually, most home countries require that the shareholder owns some minimum percentage of the investee before the shareholder may take advantage of the indirect foreign tax credit. This minimum percentage is typically in a range of 10% to 25%. The indirect foreign tax credit is also sometimes called the "deemed paid credit". With respect to the foreign tax credit computations of the shareholder, the country of the investee is the country of source.

Some countries have "unilateral" indirect foreign tax credits. This means that the rules allowing such tax credits are found in the domestic law of the country and apply generally to all residents

of that country. On the other hand, some countries have no “unilateral” rules, but rather allow such tax credits only where they have been agreed in tax treaties with other specific countries (“bilateral”). In these latter cases, an indirect foreign tax credit would only be allowed for taxes paid to such other treaty countries. In addition to allowing such tax credits where domestic law might not otherwise allow them, tax treaties will sometimes also clarify the rules of calculation of indirect foreign tax credits and may also allow such credits to a larger class of taxpayer. For an example of the latter point, maybe the domestic law of a country will provide that the indirect foreign tax credit is only allowed where the shareholder owns 25% or more of the shares of the investee. In such a case, a tax treaty might reduce that percentage ownership requirement to 10%.

Contrast of direct foreign tax credit and indirect foreign tax credit

The best way to describe the indirect foreign tax credit and to contrast it to a direct foreign tax credit is through an example. As will be seen, a basic conceptual point is that the indirect foreign tax credit mechanism is meant to achieve for the shareholder’s taxation of its dividend income from the investee roughly the same economic result that that shareholder would have if it chose to do business in the source country through a branch (i.e. a permanent establishment) rather than through an investee (or subsidiary as would typically be the case where the shareholder wholly owns the investee). Recall that if the shareholder had conducted its business in the source country through a permanent establishment, the shareholder would have a direct foreign tax credit for any source country tax paid and the indirect foreign tax credit mechanism would not be relevant.

Many countries have adopted the indirect foreign tax credit mechanism into their domestic tax laws. The principal intent is to provide their resident taxpayers with the ability to freely choose their form of organization for operations in other countries (e.g. branch or subsidiary) without having to consider the residence country tax rules.

Let’s first do a very simple example without involving the foreign tax credit limitation formula to illustrate the point. Then, below, we will assume a more complicated situation so that the manner of calculation including that of the limitation formula can be better understood.

Assume first that X, a resident of country A, conducts business through a permanent establishment in country B. X’s pre-tax earnings in country B are 100. The respective tax rates are 40% in country A and 30% in country B. Assume further that country B has a 10% branch profits remittance tax. (For the subsequent comparison where X operates through a subsidiary (i.e., an investee) rather than through a permanent establishment, we will similarly assume that country B has a 10% dividend withholding tax.) For simplicity, it is assumed that X has no income other than what it earns in country B.

Calculation of Country B Tax:

Country B earnings	100.0	
Country B tax rate	30%	
	30.0	
Country B 10% branch profits remittance tax	7.0	(10% of 100 earnings less 30 tax)
Total country B tax	37.0	

Calculation of Country A Tax:

Total income	100.0
Country A tax rate	40%
Tax before credit	40.0
Direct foreign tax credit	(37.0)
Country A tax due	3.0

Total Taxation:

Country A tax	3.0
Country B tax	37.0
Total tax	40.0
Combined effective tax rate	40%

[Continue on following page.]

Now assume that X is a shareholder and has no permanent establishment in country B but instead operates in country B through its wholly owned subsidiary Y (an investee) and that all earnings of Y are immediately distributed by Y to X. Assume all other facts to be the same.

Calculation of Country B Taxes:

Country B earnings of Y	100.0	
Country B tax rate	30%	
Direct country B tax on Y	30.0	
Country B 10% dividend withholding tax on X	7.0	(10% of 70 dividend)
Total country B taxes	37.0	

Calculation of Country A Tax on X:

Dividend income	70.0
"Gross Up" for tax paid by Y	30.0
Country A taxable income	100.0
Country A tax rate	40%
Tax before credit	40.0
Direct and indirect foreign tax credit	(37.0)
Country A tax due	3.0

Total Taxation:

Country A tax	3.0
Country B tax	37.0
Total tax	40.0
Combined effective tax rate	40%

You will of course see from the above that the combined effective tax rate in both instances is 40%. Thus, the overall intent of the indirect foreign tax credit is achieved. That intent, again, is to equate from the country of residence's perspective the economic tax situation between operating through a branch (i.e., permanent establishment) and a subsidiary (i.e., investee) in a different country. In this manner, X, whether in its capacity as a taxpayer operating directly in country B or as a shareholder owning an investee that conducts business in country B, ultimately bears an overall tax cost that is equal to the higher of the residence country (country A) and the source country (country B) tax rates. The following table reflects the above and also

adds in a column showing the double-taxation that would result if there were no indirect foreign tax credit mechanism.

		Branch of X in Country B	X Owns Sub Y in Country B: No Indirect Foreign Tax Credit	X Owns Sub Y in Country B: With Indirect Foreign Tax Credit
A	Revenue	1000	1000	1000
B	Expenses	900	900	900
C	Net Income	100	100	100
	Country B Tax			
D	30% + 10% Profit Remittance Tax	37		
E	30%		30	30
F	10% Dividend WH Tax		7	7
G	Country A Tax before FTC at 40%*	40	28	40
H	FTC Limitation	40	28	40
I	FTC Allowed	37	7	37
J	Country A Tax Payable G - I	3	21	3
K	Total Tax Obligation (D or (E+F)) + H)	40	58	40

Assumptions:

--All Revenue and Expenses are in Country B
--In 1st case, Revenue and Expenses are directly earned/incurred by X
--In 2nd and 3rd cases, Revenue and Expenses are directly earned/incurred by Y
--X has no income or operations in Country A
--Y distributes its entire after tax income of 70 as a dividend to X
--Country B has a 30% tax rate. It also imposes a 10% dividend WH Tax and a 10% Profits Remittance Tax on the net income of branches
--Country A has a 40% tax rate

* The tax base for column 3 is the sum of the 70 dividend plus the 30 "gross-up" for the Country B tax paid by Y

More complex example

Now for a more complex situation. Say that a shareholder (again referred to as X) resident in country A owns 60% of the shares of an investee corporation (referred to as Y) that is a resident of country B. Assume that the 40% shareholder of Y is a resident of country B and is not considered further in this example. Say further that the tax rates of country A and country B are 40% and 30%, respectively. During the current year, Y has pre-tax net income of 100 to which the local 30% tax rate is applied. Thus, there is 70 of retained earnings that may be distributed by Y to its shareholders as dividends. Say that Y declares and pays a dividend of 40 out of the 70. After a 10% dividend withholding tax, X as the 60% shareholder will receive a net cash dividend of 21.6 (40 total dividend x 60% ownership interest less 10% dividend withholding tax of 2.4). Note that the dividend withholding tax of 2.4 is a direct tax and is not affected by this indirect tax credit mechanism. Thus, the "gross dividend" is 24.

If there were no indirect foreign tax credit mechanism, then X's tax computation at this point would be as follows:

Gross dividend	24.0
Country A tax rate	40%
Tax before credit	9.6
Direct foreign tax credit	(2.4)
Country A tax due	7.2

Economically (as shown in the immediately following calculation), in this situation where the indirect foreign tax credit mechanism is not applied, the combined effective taxes on both Y and X on only the income related to the dividend is a very high 58%. This 58% is calculated as follows:

[Calculation on following page.]

Tax on Y (portion applicable to X's 60% ownership percentage and for Country B only)

$$\frac{\text{Dividend to X } 24}{\text{Total after tax earnings } 70} \times \text{Direct Tax on Y } 30 = \quad 10.3$$

Tax on X (Country A and Country B)

Country B withholding tax on dividend	2.4
Country A direct tax on dividend	7.2
Total Combined Taxation	19.9

Effective Tax Rate $\quad \frac{19.9}{34.3^*} = \quad 58.0\%$

*Pre-tax income of Y related to dividend to X:

$$\frac{\text{Dividend to X } 24}{\text{Total after tax earnings } 70} \times \text{Y's pretax income } 100 = \quad 34.3$$

The following will illustrate the indirect foreign tax credit in order to show its effect in reducing the effective tax rate from 58% down to the higher of the residence country and host/source country tax rates. The initial computation calculates X's taxable income in country A.

Gross dividend	24.0
Dividend "Gross-Up"	10.3**
Total Taxable Income	34.3

** Gross-Up Formula: $\text{Gross-Up} = \frac{\text{Dividend Received by X } 24}{\text{Total After-Tax Earnings } 70} \times \text{Tax Paid } 30$

$\text{Gross-Up} = 10.3$

The next step is the calculation of the tax based on country A's tax rates.

Total Taxable Income	34.3
Country A tax rate	40.0%
Tax before foreign tax credit	13.7

The next computation is to determine the amount of available direct and indirect foreign tax credits that may offset the above country A tax amount.

Direct foreign tax credit	2.4
Indirect foreign tax credit	10.3***
Total available tax credit	12.7

*** The indirect foreign tax credit is the same as the calculated “gross up”.

Finally, we determine the tax payable to country A.

Tax before foreign tax credit	13.7
Total available tax credit	12.7
Tax payable to country A	1.0

The combined effective taxes on both Y and X on only the income related to the dividend is now limited to 40%, the higher of the tax rates of the two countries. This effective rate is calculated as follows:

Tax on Y (portion applicable to X’s 60% ownership percentage and for Country B only)

$$\frac{\text{Dividend to X } 24}{\text{Total after tax earnings } 70} \times \text{Direct Tax on Y } 30 = \quad 10.3$$

Tax on X (Country A and Country B)

Country B withholding tax on dividend	2.4
Country A direct tax on dividend	1.0
Total Combined Taxation	13.7

$$\text{Effective Tax Rate} \qquad \frac{13.7}{34.3} = \qquad 40\%$$

Similar to what was said at the conclusion of the more simple example above, in this more complex example as well, the indirect foreign tax credit has achieved an overall effective tax rate on the income distributed to X that is equal to the higher of the residence country (country A) and the host/source country (country B) tax rates.

M. Form of doing business in a country

Forms of doing business—definitions and background

While there is some variation around the world, a corporation or other investor from one country that is planning to conduct business within another country typically has a choice of the following alternatives:

- No Direct Presence
- Representative Office
- Branch of Foreign Legal Entity
- Corporation or Other Legal Entity Established under the Local Country's Laws

Often, especially where the importation and sale of a product is involved, sales may be made through a local distributor, agent, or commissionaire in conjunction with one of these forms of doing business. Consignment sales are also sometimes made internationally.

In order to set the stage and provide the context for further discussion, we must say a few words about each of these forms as well as about distributors, agents, and commissionaires. For consistency, we will assume that corporation X from country A wants to conduct its business in country B. If it does so through a subsidiary or an investment in some other type of entity, then we will refer to that subsidiary or entity as Y. Where applicable, we will also refer to an X subsidiary or other type of entity in a third country (country C) as Z. We will refer to an agent or commissionaire as G and a distributor as D. For simplicity in this discussion, we will assume that X owns 100% of Y and Z and will not be involved in any local joint venture. In addition, although the discussion has been written assuming that G and D are not related to X, Y or Z, be aware that X could have business reasons for establishing its own agency, commissionaire, or distributor operation in country B. In such a case, the same business arrangements described in this Section M could involve related rather than unrelated parties.

No Direct Presence

Depending on the business of X, it may be able to sell to or otherwise service customers in country B without opening its own office in country B. For example, if X manufactures in country A a product that it wants to sell in country B, it could advertise the product in local advertising media and sell only when it receives an order at its headquarters in country A from a country B customer. The products would be shipped directly to the customer and imported by the customer. X could also send its sales and technical personnel on short trips to country B. If X were in a service business such as consulting, it would likely do much of the service work in country A but would send its personnel when necessary to country B to gather information and present its findings to a country B customer.

X could appoint G as an agent or commissionaire in country B to represent it. Typically, there would be an agreement between X as principal and G as agent or commissionaire.

X could enter into a distribution agreement with D.

X could place one or more of its personnel on “secondment” with a local agent, commissionaire, or distributor.

The above paragraphs in this section focus on there being “no direct presence” of X in the country where the customer is located. This “no direct presence” condition can also be applicable to countries where manufacturing or other processing or supplier activities will be conducted. The typical approaches to achieving this are through contract manufacturing or tolling arrangements.

- Generally, in contract manufacturing, one party contracts with another party that has certain manufacturing capabilities for the manufacture of goods to be produced to the first party’s specifications and that utilize intangibles (e.g. patents, know-how, trademarks, etc.) owned by that first party. Typically the contract manufacturer will purchase raw materials from unrelated parties and will sell the finished goods to the first party. Sometimes, though, the first party may supply to the contract manufacturer some or all of the raw materials or components. It may also occur that the first party will purchase some or all of the raw materials and will pay the contract manufacturer a service fee for the processing, thus continuing to own the raw materials as they become work-in-process and later finished goods. The first party will typically pay a price for the goods (or a service fee) that reflects a cost-plus or other service-based pricing method since the principal commercial risks (e.g. inventory obsolescence, finding customers, risk of manufactured products becoming obsolete, customer credit risk, etc.) are being borne by the first party with the contract manufacturer merely taking on a service role of producing to the first party’s specifications. This cost-plus or other service based pricing also reflects the fact that the intangibles required to produce the goods belong to the first party. Thus, there is no need for the contract manufacturer to be paying any royalty to the first party.

- A tolling arrangement is economically similar to contract manufacturing, but usually the first party will own the raw materials, work in process and finished goods while the other company (the tolling party) processes them into products. In addition, the first party will normally have imported the raw materials into the country of the tolling party. The first party will pay a service fee to the tolling party and will not be “purchasing” the finished goods. Some countries recognize tolling arrangements in their custom duty laws and allow raw materials to be imported, processed, and exported without the payment of (or by allowing a refund of) value added taxes, import and export duties and other related charges.

Through contract manufacturing and tolling arrangements, a country A company may effectively conduct manufacturing, processing or other supplier activities in country B without creating a direct presence in country B.

Representative Office

X may want to have its own personnel present in country B. However, X may want these X employees to limit the extent of their activities for various business, tax, and legal reasons. These limited activities to be conducted might include market research and analysis, promotion of the company's products, supervision of and liaison with agents, commissionaires and distributors, unpaid technical support to distributors and other customers/users of the products sold, and other limited activities that fall short of concluding contracts with customers. Such activities can also sometimes include product sourcing or buying functions when X opens an office locally for the purposes of sourcing products that X will purchase and resell to its customers outside of country B.

A particularly important point to note in regard to the activities of a representative office is that the activities must be for the benefit of the company of which the representative office is a part. The activities must not benefit some other legal entity. Thus, for example, if X is manufacturing goods in its home country (country A) and has opened the representative office in country B for market research in relation to those manufactured products, then that is a proper use of a representative office. However, if the goods are manufactured by company Z (whether related to X or not) and are to be sold by Z directly to customers in country B, then the same market research activities in country B by X will not typically be true representative office activities. In such a case, X is performing income-producing services for Z since Z would have to pay X for these market research activities. Such income producing services would normally cause a need to register a branch.

This point that the representative office's activities must be on behalf of the entity of which the representative office is a part is emphasized in the terms of most tax treaties. In particular, see paragraph 4 of Article 5 of the OECD Model Tax Convention. The activities mentioned therein expressly must be for the "enterprise" that is conducting the activities.

Similar to the "no direct presence" alternative above, X could have agreements with one or more agents, commissionaires and distributors.

A number of countries (i.e., country B) allow foreign country taxpayers like X to open offices that carry on only limited activities. Typically, in such situations, the local country's laws (companies act, corporate law, tax laws, etc.) and practices allow such companies to avoid both any local companies law reporting and income tax reporting. Such companies are treated as if they have no business activity and no locally sourced income. Often, there are only employee withholding tax and relevant payroll tax filings required and no corporate income tax or value added tax filing requirements. (See also "Issue 5.4 Commercial Representations" in section 5.d. of Part III, "Issues arising under Article 5 (Permanent establishment) of the Model Tax Convention", of 2002 Reports Related to the OECD Model Tax Convention, No. 8, Organisation for Economic Co-Operation and Development, 2003.)

Note that similar to the discussion below for a branch, a representative office is not a separate legal entity from the entity of which it is a part.

Branch of Foreign Legal Entity

In the case of a branch of X in country B, this normally means that X has registered under the local companies act, corporate law, or other relevant legislation to allow it the right to conduct business in country B. As such, X can conclude sales contracts locally, its personnel can perform income-producing services and invoice the customers or clients, X can be paid by customers locally, etc. Typically, X through its country B branch can conduct any activity that would be lawful for a company locally formed under country B's laws. (There will on occasion be exceptions to this "typical" situation due to business licensing or other local country B requirements.)

Typically, upon registration of a branch, the country B income tax authorities will require that all corporate income tax returns, VAT returns, etc. be filed. As such, X will normally be fully taxable in country B on any income arising from activities conducted in country B, it will have VAT collection and filing obligations, etc. X will also be subject to any branch profits remittance tax where there is one in country B. As a branch, X will normally have employees in country B. As such, it will have to make employee withholding tax and relevant payroll tax filings (e.g. unemployment insurance, required social insurance and retirement benefits, etc.).

Similar to the other alternatives above, X could have agreements with one or more agents, commissionaires and distributors in country B.

A particular point to understand is that a branch of X (as well as a representative office) in country B is not a separate legal entity. X is the taxpayer and has assets and activities in country B. Country B has jurisdiction over these assets and activities. While some countries will for some purposes attempt to treat a branch as if it were a separate legal entity, it is in fact not a separate legal entity. As such, typically, X is liable for all obligations of the branch, the branch accounts are fully included in the accounts of X, any contract signed in the name of the branch will create rights and obligations for X, cash may be transferred between the home office and the branch without any tax effect, income and expenses may be received or paid either by the home office or the branch with there being no differing tax effect, etc.

Corporation or Other Legal Entity Established under the Local Country's Laws

X may choose for various business, legal, and tax reasons to form a corporation or other legal entity (Y) in country B. Country B law will define the entities available and their respective characteristics. Many countries provide for traditional corporations, the shares of which may be either publicly or privately held. Often, there is also a corporate vehicle, often with a lower minimum capitalization level and simpler governance provisions, that may only be privately held. Limited liability companies are also found as are partnerships. Typically, limited liability companies will be treated as taxpayers under local law. While partnerships will usually be transparent for tax purposes, in some countries they are treated under the tax rules as taxpayers in much the same manner as corporations are treated.

Reasons for X choosing to form Y rather than merely registering a branch of X include:

- Desire for limited liability

- Appearance in local environment of greater commitment from having a well capitalized locally formed subsidiary—this can be important to customers, prospective employees, creditors, etc.

- Local licensing requirements (conducting certain businesses may require a license that will only be granted to locally formed entities)

- Ability to qualify for local incentives (e.g. loans, training grants, special taxation regimes, etc. may only be applicable to locally formed entities)

- Ability to purchase real property or other restricted assets (the purchase of real property, certain assets such as natural resources, shares of certain strategically important companies, etc. may only be allowed to locally formed entities)

- Requirement in local law that operations be conducted in a locally established legal entity with local equity participation

- Higher degree of comfort with intra-group transfer prices where, for example, goods are manufactured in country A and will be sold through a sales office in country B—in such cases, there is potentially a greater degree of comfort in transfer pricing supported by invoices and other relevant documentation between two legal entities (i.e. X and Y) in comparison with management decisions made internally within X on how much profit to attribute to a country B branch sales operation (see further comments below in "Differences between branch and subsidiary taxation")

- Assurance that country B tax is imposed only on income from targeted activities placed within Y, thereby eliminating any impact from country B's application of the "force of attraction" doctrine to other income of X

- Ability to apply different (and potentially more favorable) foreign exchange translation rules that apply in country A for a legal entity in comparison to a branch (documentation and accounting requirements may also differ)

Typically, Y will conduct a business in country B. Such business could include manufacturing products, the importation of goods and the holding of inventory, the sale of goods to customers (e.g. distributors, wholesalers, retailers, end-users, etc.), the performance of services, the sale or rental of tangibles or intangibles, etc. Similar to the other alternatives above, X (or Y) could have agreements with one or more agents, commissionaires and distributors in country B. In the conduct of Y's business Y may make purchases and sales of products either from or to related parties or unrelated third parties. Similarly, in respect of the performance of services, the rental of property, etc., Y may transact with related or unrelated parties.

Note that X could choose to form a corporation or other legal entity (Z) in a third country (country C) and then have Z form a representative office or branch in country B. This can

sometimes make good sense in international tax planning. It may also be possible in some circumstances for Y to be a dual-resident company (i.e., resident under the domestic tax laws of, for example, countries A and B so as to be taxable under each country's regime as a resident). This might be desirable, for example, where there will be a considerable period of start-up losses within Y in country B that might be used against other income being earned in country A either by Y or, more likely, by Y's country A affiliates where liberal consolidation or other loss relief rules apply in country A.

This Section M on "forms of doing business" focuses primarily on an operating company from one country that wishes to extend its operations into another country through internal growth. It will often happen, though, that such a company (X in country A) may choose to enter another country not through internal growth but rather through the acquisition of a target company or target group (T in county B). As such, X's goal is to acquire, through alternatively a taxable purchase or a tax-free share exchange, all the shares of T or a portion or all of T's assets. In the case of a purchase of T's assets, X will typically form a locally incorporated entity (Y) and will use it as the acquisition vehicle. Alternatively, X could form a branch in country B for the asset acquisition, although this is less common.

When X will be acquiring T's shares, whether by purchase or by share exchange, X will normally have to decide whether to make the share acquisition directly or through a newly formed Y in country B that will be used as the acquisition vehicle. (X could also form a country B branch to make the share acquisition or form Z in a third country (country C) for the acquisition. These alternatives are beyond this present discussion.) There are numerous financial and tax issues that may be important to this decision of an acquisition directly by X or indirectly through Y as an acquisition vehicle. Local law in country B will determine what and how relevant these issues are. These issues may include:

- Repatriation of investment—When X forms Y, it might choose to capitalize it with both equity and inter-company debt. While the interest on the debt will typically attract an interest withholding tax in country B as will dividend payments made by Y to X, the interest due and debt principal provide a mechanism for the easy repatriation of funds to X. Such funds can include either excess cash in the target at acquisition or cash generated later through operations. Often, due to domestic rules allowing inter-company loans between residents or dividends to be paid by one resident to another without any tax consequences (i.e., dividends paid by T to Y), it may be easy and without additional tax cost within country B for excess funds within T to be loaned or distributed to Y. Y would then use those funds to make interest payments or repay debt principal to X.

- Step-up in basis of T's assets—It can of course occur in an acquisition that the purchase price of the T shares is in excess of the inside tax basis of T's net assets. Some countries will allow a step-up in the tax basis of T's net assets to the price paid for T's shares when T is subsequently liquidated or merged into Y. Such a post-acquisition liquidation will not be possible when X has directly acquired T's shares. (Countries in Asia generally do not have any tax law that is equivalent to Internal Revenue Code section 338 in the US, which allows an election to step up the basis of T's assets even in the absence of a liquidation or merger of T into the acquiring company Y.)

- Availability of local financing—Attracting local sources of financing to support an acquisition will often be easier where Y, as borrower, is used as a locally incorporated acquisition vehicle. Even where such local sources agree to support the acquisition through loans directly to X, there may be disadvantages. First, a loan to X will normally mean that more than just X's investment in T is subject to the claims of the country B creditors. Second, interest paid by X to country B creditors may be subject to country A interest withholding tax.

- Deductibility of interest charges against T's operating earnings—By incurring interest charges within Y, it may be possible to achieve a tax deduction for these costs against T's post-acquisition operating earnings. This could occur through available country B consolidation or loss relief rules. Or, it could occur for interest incurred subsequent to a liquidation of T into Y or merger of T and Y.

- Facilitation of local equity participation—Where there is a local partner who is to have an equity position in the acquisition, Y provides a vehicle for that. Some countries have local-equity participation requirements. Further, shares in Y could also be used for equity-based compensation.

- Facilitation of acquirer country planning—Where X is a US company, it may desire to use as an acquisition vehicle a local entity for which it can make a "check-the-box" election under Treasury Regulation section 301.7701-3.

Distributor

Typically, a distributor (D) is a country B company that will enter into an agreement with X (or sometimes Y or Z) to purchase product and resell it to wholesalers, retailers, or end-users in country B. Often, there will be a distribution agreement signed by D with X (or Y or Z). This distribution agreement will include commercial terms that may cover pricing, exclusivity of selling activity, terms of payment, timing of delivery, quantum of inventory D will hold, minimum level of annual sales, local advertising that X or D will provide, etc.

Under typical circumstances, D will take the risk of holding inventory and all credit risk of the customers. D will earn gross profit, the amount of which will reflect the commercial risks it is taking.

Normally, D will purchase from X and will be the importer of record with respect to the products. As a result, in the absence of other activities by X in country B, X is usually not considered by country B to be conducting a business or to be selling product in country B. This normally means that X will not become subject to corporate income taxes or VAT in country B on the income from its sales to D. As importer of record, D will typically pay any customs duties and VAT due at the time of importation.

Agent and Commissionaire

Typically, an agent (G) is a company in country B that will enter into an agreement with X (or sometimes Y or Z) as principal, to act as an agent on X's behalf in the conduct of X's business.

As such, G as agent represents X by promoting X's products or services and working to secure contracts with third party customers for sales or the performance of services by X.

An agency agreement may provide for an agent to exclusively represent its principal or alternatively an agent may represent many principals. The agreement will provide for the degree of authority that the agent has in representing and negotiating with third parties on behalf of the principal. In some cases, the agent may hold the authority to enter into sales or other types of contracts that legally bind the principal with third parties.

The agency agreement will also include commercial terms covering matters such as pricing to third parties, credit requirements for prospective customers, the calculation and terms of payment of the agent's commission, the quantum of inventory, if any, that the agent will hold for the principal, any local advertising that either party will provide or otherwise bear the cost of, etc.

Typically, the principal will take the credit risk if a customer does not pay. However, in some cases, the agent will assume this responsibility.

An agent may hold some inventory for the principal although it is probably more common for the agent to not be responsible for holding inventory. Even where the agent does hold inventory, usually the agent does not purchase and re-sell the inventory. Rather, the agent holds it for the principal with sales of such inventory being made in the name of, for the account of, and on behalf of the principal.

G will earn a service fee from its agency activities rather than gross profit from the sale of products. The amount of such service fees will reflect the commercial risks it is taking and may have incentive features depending on results. Where G takes neither customer credit risk nor inventory risk nor bears any local advertising costs, its service fees earned will, relatively speaking, be less than the gross profit that D would earn where D as a distributor takes such risks and bears such costs. Note that D's gross profit is the difference between D's sales proceeds to its customers and its product costs paid to X.

Through the use of G as agent, X will often be able to indirectly operate in country B and avoid any need to register its own representative office or branch. Further, where an agent's powers to contractually bind the principal are limited (and of course there are many exceptions and the specific facts must be reviewed carefully), the country B tax authorities will typically not treat X as conducting a business in country B. And this means that X should have no corporate income tax obligation (and having no employees of its own, X as well will have no payroll tax obligations). This result of no local corporate income tax arises from the domestic laws of many countries as well as in virtually all bilateral income tax treaties. See the definition of "permanent establishment" in Article 5 of the OECD Model Tax Convention. See also Article 12 concerning "Artificial Avoidance of Permanent Establishment Status through Commissionnaire Arrangements and Similar Strategies" in the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting released on 24 November 2016.

Note that the US domestic law, contrary to that of a number of other countries, has a very broad definition of "US trade or business", causing potential income taxability (i.e., "effectively

connected income”) whenever a foreign principal operates in the US through an agent, even if that agent holds limited authority to bind the foreign principal.

Where G does have the power to contractually bind X, X will often be treated under local tax rules and under the terms of most tax treaties as if it were directly conducting business in country B with the full tax consequences that would arise if X maintained a branch in country B. This is often termed a “dependent agent branch” or “dependent agent permanent establishment”. Where such a branch is deemed to exist, there can be particular fuzziness in determining the amount of gross income and related expenses that are attributed to the activities of this taxable make-believe branch. (Some general aspects of difficulties involved in calculating income of a branch are discussed in the following section. These can be even worse for a dependent agent branch.) Note that although X may be subject to local income taxation, as long as it has no employees of its own in country B, there should be no employer reporting and payroll tax responsibilities. Note also that above-mentioned Article 12 in the Multilateral Convention, which expands the situations where X will be deemed to have a permanent establishment causing country B taxation, reflects international concern that many multinationals have abused these treaty provisions through their tax-motivated structuring of transactions.

Even if G does have the power to contractually bind X, some countries and most tax treaties will still relieve X from any income taxation if G is, in fact, an agent of independent status. While definitions may vary, such an agent is typically one that is financially and operationally independent of the principal. Where G is operating for only one or more principals, all of whom are related, it is normally difficult to support its status as being independent of those principals. Where Article 12 of the Multilateral Convention applies to such a situation of an agent operating for only one or more related principals, it will be impossible to support that the agent has an independent status. A good example of the type of entity that is clearly an agent of independent status is the large Japanese trading company, a number of which have operated in Japan and internationally for many years.

Whether or not X is determined to have any income tax obligation, there may still be value added tax and import duty concerns unless any inventory held in country B is held in bond and is only imported through customs at a time when the customer takes delivery as importer of record. Where products clear importation procedures prior to sale, there can be practical difficulties for X to satisfy all requirements and make payment of applicable VAT, customs duties and other charges if it has not registered a branch, as would be typical of many situations where an agent is being used. Often, the agent and/or applicable logistic services providers will perform such functions on behalf of X.

In contrast to a typical agency relationship, some countries, in particular civil law countries, provide in their local law for a commissionaire relationship between a principal and a company acting as the commissionaire. While this is similar to an agency relationship, there are important differences. Generally, under such a relationship, the commissionaire acts on behalf of and for the account of the principal in selling products, but does not do so in the name of the principal. Rather, the commissionaire sells to customers in its own name with the customers having no knowledge of the identity or existence of the principal. Consistent with this lack of

knowledge of the principal, the customers have no privity of contract with the principal. As such, the principal and the customers do not have contractual rights against each other that can be exercised directly. They each only have such rights against the commissionaire.

In common law countries, it may be possible to approach the terms of a commissionaire relationship through an agency with an undisclosed principal.

Because of the peculiar nature of a commissionaire relationship, it may be possible for X (or Z) to maintain that it has no taxable presence in country B despite the activities that the commissionaire performs on its behalf. In all cases, local commercial law as well as local tax law and any applicable tax treaties must be examined. In addition, the tax authorities and commentators in a number of countries have questioned whether, and have sometimes concluded that, such arrangements create a taxable presence for the overseas principal. The typical concern is that the commissionaire is a dependent agent of the foreign principal. Also, even in the absence of an income tax presence, there may be value added tax and import duty consequences that must be considered. (For current controversy and background regarding commissionaire arrangements, see discussion beginning with item 19 on page 33 of the OECD Revised Public Discussion Draft concerning "Interpretation and Application of Article 5 (Permanent Establishment) of the OECD Model Tax Convention", 19 October 2012. More recently, the BEPS project has recommended changes to the OECD Model Tax Convention regarding commissionaire structures and where Article 12 of the Multilateral Convention applies, such structures will generally cause X to have a taxable presence, or permanent establishment, in country B.)

There is one final point that can potentially apply to distributorships, agencies, and commissionaires in some countries. This is that local law may provide a distributor, agent or commissionaire with a vested right to its position, even in the absence of written contract terms to that effect. As such, if a foreign principal decides to terminate the relationship, the local company holding the position may have a legal right to compensation from the principal. While this is not usually important from a taxation perspective, it can potentially create an inter-company pricing risk in a related party situation when such a relationship is terminated. The risk is that the local distributor, agent or commissionaire will have income imputed to it upon the relationship's termination.

Secondment of personnel

Personnel from X can be "loaned" to a local agent, commissionaire, distributor, or other company in country B, whether related or not. Typically, such loaned employees are furthering the business of the company to which they are loaned and, as such, they do not normally cause X to be seen by the country B tax authorities as doing business within or having a permanent establishment in country B. See Section T for additional comments on secondment.

<u>Differences between branch and subsidiary taxation</u>

The rules in various countries, whether affected by a tax treaty or not, are typically reasonably fuzzy regarding how much profit to attribute to activities that are conducted through a branch.

For example, where a branch of X in country B is selling products manufactured in X's home country A, the first reaction of country B's tax authority's may be that 100% of the profit (sales price to customer less manufacturing costs and other expenses) should be taxable in country B. X might try to use a fair internal intra-company transfer-price in preparing its branch accounts and tax filings, but such intra-company pricing, by its nature, will be somewhat arbitrary with likely no documentation (other than the taxpayer's own computations) to back it up.

In contrast, where X forms a subsidiary Y for the sale of country A manufactured products into country B, there will be an actual inter-company transfer price between two legal entities (X and Y) that is reflected in various documents (e.g. purchase orders, invoices, importation documentation, etc.). The legally agreed terms of such sales will likely be set out in a distribution agreement between X and Y. And under that distribution agreement, issues such as which of X and Y will bear various costs and risks will be clearly set out. For example, X could contractually bear some portion or all of the local advertising costs as well as the risk of inventory obsolescence. It could also bear the credit risk of non-payment by Y's customers if that were desired. In contrast, where X sets up a sales branch, there will be no clear contractual terms that set out what costs and risks will be borne by the branch and those that will be borne by the X home office. The lack of such contractual terms of course reflects the reality that X's home office and its sales branch are merely portions of one legal entity.

In addition to the bearing of costs and risks, where there are two separate entities (X and Y), the inter-company transfer price will reflect any intangibles that each company owns. For example, X may own valuable product and manufacturing patents and know-how as well as trademarks and trade names while Y may own certain marketing intangibles within country B concerning local distribution channels. It is clear which intangibles X owns and which Y owns. Where X operates a sales branch in country B, as above with costs and risks, with X and its sales branch being a single legal entity, there is no clarity regarding which intangibles should be considered to exist only in country A and wholly or partly in country B. Again, this makes the determination of a fair intra-company transfer price very difficult.

While many countries may have little in their laws about calculating the income of a branch, they often will have transfer pricing rules that will provide an arm's length standard for inter-company transactions, such as in this case, where there is an actual sales price for the products sold by X to Y. Where a tax treaty exists, typically an associated enterprises article supplements local transfer pricing rules (see Article 9 of the OECD Model Tax Convention). And, for calculating the income of a permanent establishment where a branch has been used, treaties will normally provide an arm's length standard for intra-company transfer-pricing (see Article 7, paragraph 2 of the OECD Model Tax Convention) so that in theory the same transfer-pricing rules should apply similarly to both intra-company and inter-company transactions. Despite this, there are still actual and subjective differences because, for intra-company transfer pricing, there is no legal documentation supporting the branch's gross profit calculation (i.e., no invoices and no distribution agreement) and no clarity regarding what intangible property and risks should be treated as wholly or partly existing or being borne within the branch.

The above subjectivity regarding the splitting of functions, costs, risks, and assets between a home office and branch is reflected in the OECD's 2008 "Report on the Attribution of Profits to

Permanent Establishments" (17 July 2008). In this document, the OECD has explored some of these issues in detail. See this document for some good discussion of the OECD suggested approach of using "significant people functions" for certain more difficult determinations. The results of this 2008 Report were generally included in the OECD Model Tax Convention and Commentary with its July 2010 revision. See further discussion of this 2010 revision below.

As an additional practical thought, it may be said that an adjustment of a branch's profits by local tax authorities may be administratively easier for them than making the complicated and time-consuming economic analysis that is typically required for a normal inter-company transfer-pricing adjustment.

Other areas of difference exist in addition to that described above for profit on sales. First, in the case of a subsidiary Y, as a separate legal entity, it of course will contract in its own name and pay all expenses it incurs. This includes payments to X for any services or other benefits that Y receives from X. A branch, though, being merely a part of an entity X, likely will not directly pay all of the expenses that benefit it. The country A home office of X may pay expenses that relate solely to the branch's operations. Further, because the time and effort of some home office personnel will benefit the branch's business, some portion of the home office salaries and other overhead costs will be properly chargeable against the income of the branch. Some countries, though, will limit what overhead and administrative costs can be allocated to a branch, thereby artificially increasing the effective tax rate on the branch's economic income. Where a subsidiary is used so that there will be one or more service contracts covering such costs, such limitations are typically less likely to apply. As an additional issue, in a branch situation many countries would only allow the actual costs incurred at the home office level to be charged against the branch's income. These countries would not allow the X home office to earn any profit element. By contrast, in the case of an inter-company charge by X to Y, the charge can normally include a profit element in addition to the actual costs incurred by X. The current OECD suggested approach would allow a profit element where supportable based on transfer-pricing principles.

As another area of difference, there is generally more ability to deduct (when appropriate to the factual situation) inter-company interest and royalties in a subsidiary situation. Country B will not normally allow intra-company interest and royalties to be deducted against branch profits, although they might allow an appropriate allocation of actual interest and royalty/R&D expenses paid to third parties. A further point is that allocating or charging actual third party interest or royalty expenses to a branch's accounts may cause unexpected withholding tax obligations in country B. This is because country B may treat such charges, even if paid from the home office in country A, as being sourced in country B. See paragraph 5 of Article 11 where this sourcing concept is applied to interest in the OECD Model Tax Convention.

There is considerable discussion of branch profit calculation in the OECD Commentary on Article 7 of the OECD Model Tax Convention as well as in Parts I through IV of the above-mentioned OECD report "Attribution of Profits to Permanent Establishments". In 2010, Article 7 and the related Commentary were extensively amended to reflect the recommendations in this OECD report. Under the newly articulated concepts, the branch is treated in a more complete manner as if it were a separate legal entity. As such, it is possible to have intra-company

interest and royalties as well as profit elements in regard to home office services and other support provided to branches. These changes will tend to result in decreased profits attributable to a permanent establishment in comparison to the pre-2010 amended Article 7. The amended language of Article 7 has been slow to enter into new and newly amended tax treaties. As a result, the prior Article 7 and its approach to dealing with intra-company charges will continue. This newly articulated OECD approach has been actively rejected by many countries, especially developing countries due to their understandable desire to maximize rather than minimize the profits of permanent establishments operating within their borders. It will be a useful exercise for the student to compare new Article 7 in the OECD Model Tax Convention with Article 7 of the UN Model Tax Convention to appreciate this issue. See in particular Paragraph 3 of Article 7 of the UN Model.

As a result of the Multilateral Convention's Article 12 expansion of the permanent establishment concept, there is an ongoing BEPS project to provide further guidance for determining the profits attributable to a permanent establishment. See Public Discussion Draft for BEPS Action 7, Additional Guidance on the Attribution of Profits to Permanent Establishments, released 4 July 2016, available at http://www.oecd.org/tax/transfer-pricing/BEPS-discussion-draft-on-the-attribution-of-profits-to-permanent-establishments.pdf.

Although not a difference between branch and subsidiary taxation, an additional issue related to this overall area of doing business in another country is "presumptive" taxation. In brief, some countries will either require or accept, as a minimum level of tax in some situations, a formula approach to determining taxable income. In Asia, certain countries readily accept branch or subsidiary income that is based on gross revenue being equal to or greater than, say, 105% of expenses. Where X has received a payment of revenue from a customer in country B, the formula approach to determining taxable income will be a percentage of the total revenue. Rather than using relatively set formulas, some others countries may tax based on negotiations between the authorities and the taxpayer. These various types of "presumptive" approaches may have basis in local law or merely be based on local practice.

As a brief example of the use of a "presumptive" arrangement, assume that X is selling directly to unrelated customers in country B. X's wholly-owned subsidiary Z, established in country C, maintains branches in a number of countries within the region, including country B. Through the country B branch, Z performs various services for X supporting X's sales to country B customers. When Z prepares its country B branch accounts and tax filings, it reflects as its gross revenue from services an amount equal to 105% of its country B branch expenses. In addition to locally incurred costs, these expenses include the salaries of any expatriate personnel working in the branch irrespective of where paid and any other expenses incurred elsewhere but allocable to the country B branch. While technically this level of gross income would be subject to country B's arm's length transfer pricing rules, local practice is to accept this level of gross income.

Carrying this example further, with a statutory tax rate of, say, 20%, this means a 1% of expenses effective tax ((105 revenue less 100 expenses) x 20% = 1) . Note in this type of computation that any non-deductible expenses will cause a higher effective tax rate. For

example, if 5 of the 100 of expenses is non-deductible, then the effective tax rate will rise to 2% of expenses: (105 revenue less 95 deductible expenses) x 20% = 2.

Some countries' practices expect higher levels of deemed income. For example, in Mainland China, a tax authority-issued circular provides for a minimum taxable profit where an actual accounting of all income and expenses is not or cannot be provided. This minimum is 15% of expenses or 15% of revenue, which would be applicable where revenue is known but expenses are not known or easily supported. Local authorities throughout China may attempt to claim significantly higher rates of deemed profit that can be as high as 40%.

Determining which form of doing business to use

Of course, learning about the types of forms of doing business and their characteristics is important. However, what's more important is learning the process by which a form of doing business is chosen. This process begins with fact-finding that examines (1) the characteristics of X and (2) the facts concerning the business activity it plans to conduct in country B. The next step involves applying the legal, accounting, and tax characteristics of countries A and B to the determined facts to identify issues and arrive at one or more possible structures. Finally, the results including the relative benefits and risks are presented to the decision-maker in a manner that allows a logical decision.

In the following, we will list out some of the questions about X that should be asked and also some of the possible activities that X might conduct. Within our course, we will illustrate the additional steps through discussion and case studies.

Sample questions regarding X

What is the ownership of X? Is it a public company such that X must directly own 100% of the activities in country B? Or, is it closely held by just a few shareholders? If the latter, maybe there is a possibility that the activities in country B could be owned directly by the shareholders. In some cases, avoiding ownership by X can eliminate a layer of tax in country A when dividends (or partnership distributions) are paid by Y or Z directly to the shareholders of X.

What is the tax position of X? Is it currently operating in its home country at a loss? If there are loss carryforwards, what is the "life" of those losses? Are they in danger of expiring? (Many countries allow loss carryforwards, but limit the carryforward period to just a few years.) Does X have excess foreign tax credits or excess foreign tax credit limitation? Does X file a consolidated tax return in country A or have group loss relief available to it? If X has losses, particularly if they are in danger of expiring, and the operations in country B are expected to be profitable, it might make sense to attempt to have the country B profits earned inside X so that the home country losses are utilized. (The US rules allowing a "check-the-box" election for certain subsidiaries (Y) to treat them as disregarded entities or as partnerships may accomplish this loss utilization goal without impacting the corporate status of Y in country B.) Where country B imposes a dividend withholding tax on dividends paid by Y but has no branch profits remittance tax, then the use of a branch of X (or Z) in country B may be advantageous. The foreign tax credit position of X and its ability to offset gains and losses in some manner are also

important to understanding the optional forms of doing business available and their effect on the real cost of country B taxes. For example, if X has excess foreign tax credit limitation such that it can take advantage of the country A foreign tax credit mechanism when it pays country B tax, then there will be less incentive to choose a form of doing business that minimizes country B tax.

Does X already have other operations in country B? What is the tax position of those existing operations in country B (e.g. already profitable, losses, etc.)? If X's new activity in country B will generate start-up losses, maybe the form of doing business chosen can allow these start-up losses to offset the taxable profits of these existing country B operations and/or of X's domestic country A operations.

What generally is the nature of the business of X and its third-party liability risk profile? Does it need to maintain limited liability protection between itself and the planned activities in country B? Generally, the use of a representative office or a branch will not allow limited liability. Rather, a corporation or other limited liability vehicle (e.g. LLC) would be needed.

These questions and those in the following section are only illustrative. There are many many more questions that could be asked; they will depend on the specific situation of X and its intended activities. Note that in thinking about X itself, it's worth breaking up questions into three categories: (i) the business, activities, personnel, assets (tangible and intangible), etc. (ii) the legal structure and contractual relations of the X group both internally and with third parties, and (iii) the tax status and attributes of X and its group companies.

Activities of X in country B

It is very important to understand the activities that X plans to conduct in country B. Here, we mean what X, through its personnel (including its employees, agents, commissionaires and nominees) and its assets, will do physically and contractually in country B with third parties. These activities might include any of the following and more.

- Traveling sales personnel—Sales personnel based in country A or in countries other than country B may on occasion travel into country B to promote X's product or service. They may take orders, negotiate terms of sales/service contracts, sign contracts, etc.

- Local sales agent or commissionaire—X may enter into an agency agreement with a country B company (G) under which G will represent X in country B and display samples of X's products. Sales or services will be made by X and contracts with customers will be between X and the customer without G being a party to those sales/services contracts. X might be shipping its products to the customers directly from country A or perhaps hold some inventory in bond. In either case, the importation of products would be made by the customer as importer of record. Or, X may execute a commissionaire agreement with a country B company.

- Local distributor—X may enter into a distributor agreement with D. Under the agreed terms, D purchases from X and resells to the customers it identifies. D is the importer of record and may hold an inventory of products that D has purchased from X.

- Local sales and technical support personnel—X may transfer its personnel into country B and/or hire local sales and technical support personnel to identify target customers and to facilitate sales and servicing of such customers. Where technical support personnel are involved, an important issue is whether X provides their support to country B customers free of charge or whether X imposes service charges.

- Open office of X—X may decide that it needs to have visibility in country B and to perform various sales and administrative functions locally. As such, X may decide to open an office that prominently displays the "X" company name, logo, and trademarks.

- Maintain inventory in country B—X may want to shorten the time necessary to deliver products to customers. Or, X may want to relieve the customers from customs formalities including the need for each customer to act as an importer of record. As such, X may begin to maintain inventory in country B. Such inventory might be in a customs bonded warehouse where it has not yet been "imported" legally into country B…in which case the customer will still act as the importer of record in the formal customs importation process. Or, the inventory might be in a local warehouse following legal importation for "free circulation". Another issue of holding goods in a warehouse is whether the warehouse is independently managed such that X is merely purchasing a warehousing service or whether the goods in the warehouse are managed and controlled by either X personnel or X's agent. In the former case (and assuming that X has no personnel or other activities in country B), it might be that the warehouse merely receives instructions from X personnel in country A regarding the disposition of certain inventory held in the warehouse. In the latter case, it is more likely that X's personnel or agent will take instructions on delivery directly from the customer. These differences can often result in significantly different taxation results. Importation of product also typically requires the payment of import VAT along with duties and custom declarations. In some countries this may be sufficient to create a tax presence for income taxation.

- Open a distribution center, retail store, or similar facility—X may wish to more fully control the sales process through fully owning the distribution or retail portions of the sales chain.

- Service center in country B—X may wish to more fully control the quality of its products and services by maintaining its own servicing centers for the repair of its products and the support of its users.

- Manufacturing in country B—X may wish to manufacture its products close to or inside its country B market. Will it set up its own manufacturing facilities or conduct contract manufacturing through some unrelated manufacturer that will conduct production in accordance with the specifications and intellectual property of X?

Electronic commerce has significantly affected how X conducts business in country B over the past several decades. See in particular the BEPS project Action 1 2015 Final Report titled "Addressing the Tax Challenges of the Digital Economy". It is available at http://www.oecd.org/ctp/beps-actions.htm.

N. Incentives

Many governments, in order to encourage increased local employment, faster economic growth, etc., will enact certain incentives. These incentives include:

- Income tax holidays
- Investment allowances
- Export aids (e.g. VAT systems that "zero-rate" exported goods and services, lower tax rates when certain export levels are met, etc.)
- Free trade zones
- Special customs regimes (often to encourage local processing/manufacturing of products through tolling or other arrangements)
- Regional management centers
- Special tax-favored regimes for specific activities (e.g. fund management, oil trading, etc.)
- Training grants
- Low cost land for production and other business facilities
- Low interest or subsidized loans
- Industrial parks with extensive infrastructure focused on attracting specific industries

In some Asian countries, there is significant competition in incentives to attract foreign investment. The belief, of course, is that the benefits of increased foreign investment to the local country and its people will more than offset the local costs of these incentives.

Specifically, incentives can cost a host country significant amounts of forgone tax revenue and/or increased costs. For example, a tax holiday may exempt a foreign owned subsidiary from any income taxation for several years on substantial levels of profit. An important issue is who benefits from this host country loss of tax revenue.

In the case where the foreign shareholder is located in a country that exempts its residents from tax on dividends from foreign subsidiaries (which would generally include any country using the pure territorial income basis or the hybrid-territorial income basis), then the benefit will be retained by the foreign investor. On the other hand, where the home country taxes on a pure worldwide income basis and uses a foreign tax credit mechanism, normally the taxes forgone by the host country accrue to the benefit of the home country tax authorities. The actual receipt by the home country tax authorities of these additional "forgone" taxes, though, will not occur until the foreign subsidiaries declare and pay dividends to their home country parent corporation. (See Section L herein for discussion of how home countries will often unilaterally eliminate double-taxation.)

Some limited number of tax treaties negotiated by developing countries that maintain tax incentives include what are called "tax sparing" provisions. Under these provisions, the home country of the investor calculates the foreign tax credit as if the normal host country income tax had been paid. Through this mechanism, the benefit for the forgone revenues flows to the investor and not the home country tax authorities. The point is, of course, that a developing country offering incentives expects that those incentives will have much more effect in attracting foreign investment if the investor will in fact realize the full benefit. Where there is only a timing difference because the investor's home country will later collect the foregone tax, there will understandably be less economic incentive accruing to the foreign investor.

With the increase over the past several decades of developed countries adopting hybrid-territorial income systems, the importance of tax sparing provisions has diminished. The one major developed country that still maintains a worldwide income system and for which tax sparing would be still be relevant is the US. Interestingly, however, the US as a policy has always refused to include any tax sparing provision in its treaty network. As a result, there is normally a significant incentive for US MNEs to accumulate and not distribute their low-taxed profits from subsidiaries, whether from accumulated earnings in countries like China, Thailand and Singapore where they have benefited from tax incentives directed at encouraging investment that creates local employment, or whether from low-taxed profits accumulated from BEPS structuring. Note in this regard that there is no obligation for a company to declare and pay dividends. As such, the "timing difference" from such low-taxed accumulated earnings becomes effectively a permanent savings unless economic conditions back in the US force the repatriation of low-taxed foreign earnings through dividends. This is one of the factors that has lead to the well-publicized fact that as of late 2016 US-based MNEs had more than $2.5 trillion of accumulated foreign earnings within their foreign subsidiaries. If all these earnings were to be distributed as dividends to the US parent companies, many hundreds of billions of US tax would be due.

The pharmaceutical industry has been particularly effective at this type of international tax planning. Internal Revenue Code section 965, enacted as part of the 2004 Jobs Act, provided an 85% "temporary dividends received deduction" for certain dividends from CFCs. Effectively, this temporary benefit constituted Congressional recognition of the success of this type of BEPS planning, i.e., accumulating and holding low-taxed foreign source earnings in non-US subsidiaries. As this "temporary" provision created a precedent for another similar "temporary" provision sometime in the future, Congress' action gave strong encouragement to US groups to

be even more aggressive in their planning. In addition to the pharmaceutical industry's taking advantage of BEPS planning, many other industries have done so as well over the past decade since the 2004 Jobs Act. The high-tech industry has been particularly active in this sphere from both manufacturing new high-tech products and from significant earnings gained through new internet-based business models. See in this regard the later discussion in the section on the BEPS project for Action item 1 regarding "The Digital Economy".

See also the section on the BEPS project for Action item 5 regarding "Countering Harmful Tax Practices".

O. Tax effective locations

Approach to analysis

Various published sources attempt to define the term "tax haven" and list the characteristics that tax havens provide. See, for example, Chapter 7 of Roy Rohatgi's Basic International Taxation (Second Edition), Volume Two, Practice of International Taxation, BNA International Inc., 2007, for a summary of some sources and characteristics as well as considerable additional material on the subject covering 120 pages of his text. Rather than approach the tax haven topic in a definitional manner, the approach within this course outline is to attempt to provide some brief information from the perspective of the use of such locations within the conduct of legitimate cross-border active business. We will not cover any use of such locations for pure investment purposes. For the reason that this approach is broader in scope and also to take the perhaps bad connotation of the term "tax haven" out of the discussion, we will instead use the term "tax effective location" ("TEL").

In any cross-border business situation or transaction, there will typically be up to three relevant jurisdictions:

- The home country of the business ("home country"),
- An intermediate country (may or may not be used) ("IC"), and
- The host or source country where certain business activity takes place or from which certain income is sourced ("host country" or "source country" depending on context).

Depending on circumstances, the principals behind a business or transaction might choose a country with favorable tax characteristics for any of these three jurisdictions. The following discussion initially deals with the first and third categories (i.e., home countries and host/source countries). Then, the discussion will focus on ICs.

Home country

In most cases of working with an established company, that company is already resident in its home country and the potential for it to change its residence to a TEL does not arise. However,

several examples of cases where the home country residence has been consciously planned to be in, or has been changed to, a TEL will help in understanding the potential for planning.

Inversions

In 1983, McDermott Inc., a public company incorporated in the US, went through an "inversion" transaction whereby it became a 90% subsidiary of its former 100% owned subsidiary, McDermott International, a Panamanian company. The latter became a public company that could earn non-US source income through subsidiaries directly owned by the Panamanian parent that could be distributed to its shareholders free of any corporate level US tax. With Panama (a TEL) as the jurisdiction of the publicly held company, there was no taxation at the home-country corporate level on earnings accumulated or distributed to shareholders other than those taxes imposed by the countries within which McDermott and its subsidiaries operated. There remained, of course, taxation of shareholders where their respective countries of residence imposed tax on their dividend income or on their capital gains.

This avoidance of corporate-level home-country taxation provided an important incentive. As a result, in the following decades, an increasing number of companies conducted inversion transactions to move their publicly-held parent companies out of their historical places of incorporation and/or tax residency and into tax-friendlier locations. These inversion transactions included parent companies exiting not only from the US but from other home countries as well. However, as many developed countries having transitioned from worldwide income to hybrid-territorial income tax systems over the past several decades, inversions have become principally a US phenomenon.

In the years prior to 2004 US legislation that put in place rules discouraging inversions (see Internal Revenue Code section 7874, effective for tax years ending after 4 March 2003), a number of well-publicized inversion transactions of US companies took place. These included, for example, transactions conducted by Ingersoll-Rand, Tyco, the PXRE Group, Foster Wheeler, Nabors Industries, and Coopers Industries.

For a number of years, the section 7874 rules discouraged inversion transactions. However, the increasing success of BEPS strategies and the accumulation of many billions of dollars of low-taxed accumulated earnings, which if repatriated would be subject to the 35% US corporate tax rate, increased the economic benefit potentially achievable from arranging a successful inversion. (See separate section on the BEPS project for discussion on environmental developments and systemic issues that encouraged BEPS behavior.) As a result, over roughly the past six or seven years, many US MNEs desiring an escape from the US sought out strategic merger candidates headquartered in a suitable tax-friendly jurisdiction. An attractive merger candidate was one that would not only fit together well operationally, but which had a size and value that would allow the inversion transaction to fall outside the coverage of the section 7874 rules. While a number of pharmaceutical companies have taken this route, there have also been numerous companies from other industries as well. A few examples include Valeant Pharmaceuticals International, Inc., Allergan, Inc., Eaton Corporation, and Burger King. In 2016, Pfizer Inc., a company that has been positively lusting for a more tax-friendly home country, terminated its efforts to conclude a preciously announced merger with Allergan plc.

following the issuance by the US government of certain anti-inversion rules. Pfizer had hoped for a transaction that would allow it to make Ireland its new home country. (A listing of US MNEs that have conducted inversion transactions is available at: https://www.bloomberg.com/graphics/infographics/tax-runaways-tracking-inversions.html.)

An important practical point of these tax motivated inversion transactions is that US tax rules allow an inverting MNE's management to remain in the US. As such, such transactions generally require only legal changes and do not require any significant operational changes.

Although virtually all American politicians have condemned inversion transactions with the President calling such actions "unpatriotic", there has been an inability for the various political factions to come together to take any actions that would significantly strengthen the section 7874 rules. As a result, it seems likely that US MNEs will continue to pursue inversion transactions for the foreseeable future despite the limited rules issued in 2016 that prompted Pfizer's merger termination.

An interesting footnote to this discussion of inversion transactions is that a number of inverted publicly held companies that were formerly US-based companies have again moved their "home". Previously headquartered in Bermuda or the Cayman Islands, they have changed their respective "homes" to either Ireland or Switzerland. In making their moves, these public companies expressed concern about proposed legislation in the US that could penalize such firms headquartered in tax havens through possible increased taxation or through denial of government contracts. They also expressed generally the ability to gain access to Ireland's or Switzerland's broad tax treaty networks without significant changes to their operational day-to-day activities. See "Why Inverted U.S. Firms Relocated Headquarters to Europe" by Stuart Webber, 2011 WTD 224-17, 21 November 2011.

Joint ventures

It often occurs that two or more unrelated parties from two or more different countries will form a joint venture that will operate a business that is independent to some extent of the businesses of the venturing parties. In such a case, it is necessary to select an appropriate home country for whatever joint venture entity will be formed. The analysis for this will include both the potential use of a TEL as well as the particular form of entity to use as the joint venture vehicle.

Reorganization and IPO of separately owned entities

In 2001, Accenture went through an initial public offering (IPO). The group was previously operated through a number of partnerships and other entities owned for the most part by the partners in each entity's country of formation. Immediately prior to the IPO, the group was reorganized placing all operating entities under a new Bermuda company, which then went public. As a TEL, Bermuda allowed Accenture to accumulate and distribute its earnings with no corporate level tax other than that imposed by the countries in which Accenture and its subsidiaries operate. More details are available in the prospectus filed with the Securities and Exchange Commission. It may be obtained at:

http://ipo.nasdaq.com/edgar_conv_html%5C2001%5C07%5C18%5C0000950130-01-503127.html.

In 2009, similar to the interesting "footnote" mentioned in the above section on inversions, Accenture moved its corporate headquarters from Bermuda to Ireland.

Source or host country

As has been indicated early in this paper, taxation is not normally the decisive factor driving how business operations are to be conducted. However, it can in some instances be a very important factor in some business decisions involving the location where business operations will be conducted. On this basis, there is considerable competition among various jurisdictions in the world to attract business. This is equally true domestically within the US; one only has to look at the publicized competitions among a number of states to attract Boeing manufacturing and assembly operations each time the company initiates a new airliner. (Interestingly, on 28 November 2016, a World Trade Organization panel ruled that Washington State's incentive package enacted in 2013 for Boeing put the United States in violation of its international trade obligations.) Within China domestically, there is a similar competition among cities and regions to attract new investment and expansions of existing businesses.

It should be noted that although our focus is on taxation, the competition among countries covers a number of other incentives and operational factors (see Section N). These can include infrastructure (e.g. land for new facilities, space within existing business parks, specially built structures such as roads, rail lines, docks, etc.), monetary grants (for training, new facilities, moving costs, etc.), local non-income tax abatement (property taxes, employment taxes, value added tax, etc.), importation relief (relief from import and custom duties, VAT on imports, bonded status, etc.), and legislation (e.g. investment friendly corporate provisions, etc.).

Some examples of the use of TELs as the source or host country are:

- Singapore, Malaysia, Thailand and Korea are well known for attracting manufacturing and other businesses with tax holidays and lower tax rates. China used this strategy with outstanding success for many years. Effective from 2008, though, China enacted tax reform that severely limited such incentives on the basis that the country could continue to attract foreign investment even without tax incentives.

- Hong Kong and Singapore are well known for their work to attract financial service businesses including banks, fund management, currency trading, etc.

- Singapore and Thailand have been competing with each other to retain and attract oil-trading concerns.

- Numerous countries have incentives for foreign groups to locate within their borders research and development centers and regional headquarters and personnel with regional responsibilities.

Intermediate country

Introductory comments

Cross-border businesses and transactions typically involve home and source/host countries that are defined by and depend on the specific interested parties and the nature of the business or transactions. Such home and source/host countries are typically fixed and cannot be changed through tax planning, though of course there may be alternative forms of organization available for the activities to be conducted in each country. For example, there might be choice amongst forming a subsidiary in a particular host country or establishing a branch there of either a home country entity or an entity established in a third country, in which case, that entity in the third country would be an IC entity.

Between the home and source/host entities used, there may be a variety of relationships and flows generated by them. These include:

- Invested capital (in cash or in-kind) into a legal entity and dividends there from
- Transfers of cash and property for the operation of a branch and remittances of excess cash and/or earnings from branch operations
- Loans and interest thereon
- Intellectual property and royalties there from
- Products and payments therefor
- Services and payments therefor
- Personnel
- Equipment and rental thereon

Where these flows go directly between the home and source/host countries, there will be whatever taxation arises under the domestic laws of each of the two countries as modified by any tax treaty existing between the two countries. For certain payments such as dividends, branch profit remittances, interest, royalties, rentals, and some service payments, there may be withholding taxes imposed on the gross amounts of the payments by the host/source country. Or, such payments, as well as many of the other described payments including the income of a branch, may be subjected by the host/source country to a direct tax on income net of expenses. From the standpoint of the home country, it will normally tax such receipts on a net income basis as they are accrued or received based on its domestic tax laws. The home country, whether through a domestic law exemption or foreign tax credit mechanism or due to a tax treaty between the two countries, may be obliged to grant an exemption from tax for the income from the host/source country or alternatively to allow a foreign tax credit for tax on that income.

Taxation objectives of IC entities

On occasion, it may be possible to achieve either lower overall taxes or a deferral of taxes where an IC entity is placed between the home country entity and the host/source country entity. In particular, the following are typical goals of using IC entities:

- Realizing in the host/source country the benefit of exemption or lower tax treaty withholding rates or a more limited permanent establishment definition under the IC/source country tax treaty (sometimes termed “treaty shopping”) (other treaty benefits may also arise such as access to the competent authority dispute resolution process)

  Note that the abuse of treaties was a principal focus of the BEPS project. See both the section on BEPS later in this paper as well as Part III concerning “Treaty Abuse” in the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting released on 24 November 2016.

- Changing the character of income from the perspective of the home country to reduce home country taxation (e.g. say that under the home country domestic rules dividends are either exempt or taxed more favorably than are interest or royalty income; then it would be beneficial to change the character of (i) interest income to dividend income by capitalizing an IC entity with funds that are then loaned by it to the source country entity with interest then flowing from that entity to the IC entity followed by dividends from it to the home country entity, or (ii) royalty income to dividend income by capitalizing the IC entity with funds that are then used to purchase intangibles that are then licensed to the source country entity with resulting royalty flow to the IC entity and dividend flow to the home country entity)

  This type of planning will be affected in some cases by the BEPS project’s focus on hybrid instruments and hybrid entities. See both the section on BEPS later in this paper as well as Part II concerning “Hybrid Mismatches” in the Multilateral Convention.

- Deferring income from home country taxation by retaining earnings within the IC entity (note that CFC rules in some home countries seek to prevent such benefits) or deferring with respect to the home country the triggering of currently unusable tax benefit items such as foreign tax credits

- Overcoming foreign tax credit limitation problems in the home country caused, for example, by country-by-country or other limitation computations (e.g. using a “mixer company” to accumulate dividends from both high and low tax countries so as to average the effective foreign tax rate within that company at a level that is less than the home country’s tax rate, or using an IC entity to control the timing of when foreign tax credits are triggered in the home country through IC entity dividend distributions to prevent expiration of unused credits)

Planning to minimize taxation within the intermediate country

The above four bullet points all refer to taxation issues of the host/source country or of the home country. The IC itself, of course, will normally have a taxation regime that applies to the IC entity. Any taxation imposed under that regime will reduce the contemplated benefits of using an IC entity.

In brief, the IC may impose tax directly on the income of the IC entity as well as through withholding taxes imposed on the recipients to whom the IC entity makes payments. Regarding the latter, withholding taxes may be imposed on dividend, interest, and royalty payments made by the IC entity. The IC may also impose capital taxes.

Direct IC income taxes on an IC entity are typically minimized in one of two manners.

- There may be within the IC's tax regime preferential treatment for certain types of income. One well known such preferential treatment is the participation exemption that has caused the Netherlands to be a commonly used IC. Another is a special "off shore" status under law or through a private ruling under which a territorial taxing basis is applied so that only domestically sourced income is taxed or a special low rate (e.g. 1% to 5%) is applied to foreign sourced income.

  In 2014, the "Lux-leaks" scandal showed how many MNEs have secured private rulings in Luxembourg allowing Luxembourg companies to be used as IC entities, thereby securing tax treaty and other tax benefits when earning income from other European countries. See further comments on the "Lux-leaks" matter in Section B.

  In August 2016, the European Commission announced its decision that Ireland had granted illegal State Aid to Apple through a ruling that allocated most of the earnings of several Apple Irish subsidiaries to non-taxable home offices that had neither offices nor employees. In 2015, the Commission announced a similar decision concerning Starbucks that an inappropriate Dutch advanced pricing agreement allowed income to be syphoned off from the Netherlands into a non-taxable U.K. partnership. These are additional examples of IC entities. For those looking for interesting reading, the full Apple and Starbucks decisions were publicly released in redacted form in, respectively, December and June 2016.

- Rather than relying on preferential treatments within the IC tax regime, all income is taxable, but the tax base is reduced through deductions for expenditures made, depreciation and amortization, etc. For example, an IC entity may earn interest income and then pay out both interest expense and service fees to related parties. The IC's regular corporate tax rate on net income is then applied to the small net income that remains. As an additional example, an IC entity may have purchased certain intangibles that it then licenses to a related party in the source country. The royalties are fully included in the IC entity's income, but will be offset to some extent by amortization of the purchase price paid for the intangibles. In both of these examples, if there are source

country withholding taxes imposed and the IC country allows a foreign tax credit, the IC direct income taxation may be reduced further or completely eliminated.

As will be readily imagined, if a particular country has high taxes, then it will not often be used as an IC except in peculiar circumstances. The US with its complicated worldwide tax regime and moderately high tax rates would seldom be thought of as a potential IC. However, under certain limited circumstances, even the US could be so used. For example, a US company could license foreign intangible property rights from an overseas licensor and then sublicense those same rights to another person for use in a particular source country (other than the US), the tax objective being to reduce source country royalty withholding tax through treaty shopping. The US company's net income would be taxable in the US, but this net income should be relatively small since most of the sublicense revenue received would be offset by the royalty paid to the licensor. In addition, these royalties paid to the overseas licensor would normally be free of US royalty withholding taxes since they would be foreign source income to the licensor under US domestic law.

The immediately preceding paragraph assumes a US company that is taxable as a corporation. Increasingly since the 1997 initiation of the entity classification check-the-box rules under which certain companies can be treated by election either as a corporation or as transparent (i.e., disregarded entity if only one owner or a partnership if two or more owners), non-US persons wanting anonymity for their non-US assets have formed limited liability companies, typically in states such as Delaware or Nevada. When such companies are formed and elect transparent treatment, there will typically be no US taxation since the company itself is not subject to any US tax and the non-US owner (or owners) is not subject to any US tax on the non-US income earned by the company. This has so significantly encouraged the use of the US for some IC purposes that the Tax Justice Network ranked the US as third on its "Financial Secrecy Index" in November 2015. See http://www.financialsecrecyindex.com. Interestingly, perhaps due to the embarrassment of being labeled a tax haven, the US Treasury and IRS finalized regulations in December 2016 that require informational reporting for certain foreign-owned limited liability companies that are treated as disregarded entities for US federal tax purposes. While this will not result in any additional US taxation, it will provide owner-information that the US could share with other countries' tax authorities under tax treaties and exchange of information agreements.

Non-tax objectives of IC entities

ICs may also be used for purely non-tax reasons (although tax benefits may also be achieved). Several examples of such usage are:

- Achieving and maintaining corporate ownership and control through an international holding company

- Achieving central management of cash, foreign exchange risk, borrowing of required funds, and investment of excess funds generated from and used in multiple countries

- Providing regional multiple-country management and support services to operations in each host/source country

- Achieving central ownership and management of IP

- Conducting captive insurance operations

- Conducting international shipping operations under flags that allow for lower operating costs

- Providing personnel support to operations in various countries through a "manpower" company that maintains a common payroll structure and personnel policies for all international personnel who are assigned to work in countries other than their home country

- Limiting liability and risk of asset loss in multiple jurisdictions

What is legitimate IC entity use? How do tax authorities attack the use of IC entities?

What makes the use of an IC entity "legitimate"? When is using one not "legitimate"? The answer to these questions depends on both the laws and practices of the concerned countries, the terms of any relevant tax treaty, and the particular situation of the IC entity, its related companies, and their respective activities.

Simple example – Source country reaction and tools available to tax authorities

As a first very simple example, say that an IC entity has been set up for purely treaty-shopping reasons since there is no source country/home country tax treaty while there is a beneficial source country/IC tax treaty. Say that a back-to-back loan has been set up through the IC entity with the result that the interest paid by the source country entity to the IC entity is exempted from withholding tax. Had the loan been made directly from the home country entity to the source country entity, then a 20% withholding tax under source country domestic law would have been imposed.

In a case such as this (and assuming no "limitation on benefits" or other more specific provision within the source country/IC tax treaty), we find a variety of treatments among source countries. Some countries, such as the US, will attack the structure either under domestic law "conduit" rules or under a statutory or judicially based substance approach that maintains that the IC entity is merely a nominee or agent acting for the home country entity. Some countries have general anti-avoidance provisions in their tax laws and could potentially attack such a tax-motivated structure. Courts within such countries may or may not support the ability of such domestic anti-avoidance provisions (whether specific or general) to override treaty obligations. (See further discussion on general anti-avoidance rules and "form vs. substance" concepts in Section Q below.) Other countries will respect the legal form and will seldom attack such treaty usage despite the lost taxes. Some countries may even condone such treaty use as a further means of attracting foreign investment. See paragraphs 7 through 9.2 of the Commentary on Article 1 of the OECD Model Tax Convention for further discussion of differing approaches by various countries.

In the absence of specifically applicable domestic conduit or other anti-avoidance rules or judicial practices (i.e., substance approach), a source country's tax authorities may still be able to attack the IC entity by carefully examining the facts.

- As a first example, perhaps the IC entity and its owners are not paying sufficient attention to the rules of residency in the country of establishment of the IC entity. If residency is based, for example, on management and control, then the source country authorities could maintain that the IC entity is not validly resident in the IC if the facts demonstrate that it is really managed from the country of its owners.

- As a second example, the source country authorities should look carefully at the definition of "resident", which is often found in Article 4 of many treaties. Some treaties include the following language that is from Article 4, paragraph 1 of the OECD Model Tax Convention: "This term [i.e. "resident of a Contracting State"] does not include any person who is liable to tax in that State in respect only of income from sources in that State or capital situated therein." In regard to this sentence, paragraph 8.2 of the OECD Commentary on Article 4 provides: "According to its wording and spirit the second sentence also excludes from the definition of a resident of a Contracting State foreign-held companies exempted from tax on their foreign income by privileges tailored to attract conduit companies." This language has been further expanded in the 2008 OECD Model Tax Convention update to make clear that any dual-resident person found under one treaty to be a non-resident of a country and thereby no longer subject to worldwide taxation by that country cannot claim that it is a resident for purposes of that country's treaties with its other treaty partners. See more discussion on this below in the section on Tax Treaties.

- As a third example, the source country authorities can review the "limitation on benefits" article, if any, in the applicable tax treaty, to determine if the foreign earner of the income is entitled to treaty benefits. Some number of treaties include special rules. For example, the US-Barbados tax treaty in Article 22, paragraph 6 provides that Barbados residents entitled to the benefits of certain special tax regimes in Barbados are not allowed treaty benefits in regard to reductions in withholding tax for dividends, interest and royalties.

- As a fourth example, the source country authorities may maintain that the IC entity is not the real "beneficial owner" of the income. The terms of many tax treaties regarding dividend, interest, and royalty income provide exemption or lower withholding tax rates only to the "beneficial owner" of the income. A 2003 addition to the OECD Commentary, as amended in 2014, provides: "Since the term "beneficial owner" was added to address potential difficulties arising from the use of the words "paid to a resident" in paragraph 1, it was intended to be interpreted in this context and not to refer to any technical meaning that it could have had under the domestic law of a specific country (in fact, when it was added to the paragraph, the term did not have a precise meaning in the law of many countries). The term "beneficial owner" is therefore not used in a narrow technical sense (such as the meaning that it has under the trust law of many common law countries),

rather, it should be understood in its context, in particular in relation to the words "paid to a resident", and in light of the object and purposes of the Convention, including avoiding double taxation and the prevention of fiscal evasion and avoidance." (Footnote omitted.) This is from paragraph 9.1 of the Commentary on Article 11. See also "OECD Model Tax Convention: Revised Proposals Concerning the Meaning of 'Beneficial Owner' in Articles 10, 11, and 12" issued 19 October 2012. Finally, see a summary of the history of the beneficial owner provision and other discussion in an addendum titled "Progress Report of Subcommittee on Improper Use of Tax Treaties: Beneficial Ownership", which is part of the "Note by the Coordinator of the Subcommittee on Improper use of treaties: Proposed amendments". These documents were issued in connection with certain October 2008 deliberations of the UN Committee of Experts on International Cooperation in Tax Matters. The documents can be obtained at http://www.un.org/esa/ffd/wp-content/uploads/2014/10/4STM_EC18_2008_CRP2.pdf and http://www.un.org/esa/ffd/wp-content/uploads/2014/10/4STM_EC18_2008_CRP2_Add1.pdf.

Abuse of treaty

As can be seen from the above discussion, even in the absence of any applicable specific or general provisions limiting a treaty's benefits, there are various modes of attack for local tax authorities in their attempt to deny treaty benefits. But what about local authorities' efforts to merely assert that a taxpayer's claim of treaty benefits is an abuse of the treaty and should just be denied on that basis? Is there any obligation to grant treaty benefits simply because the strict requirements of the treaty are met in legal form?

On this point, the OECD in its Commentary notes that there are some divergent opinions amongst OECD-member states. See in particular paragraphs 7 through 27.10 of the Commentary on Article 1 of the OECD Model Tax Convention and paragraphs 43 through 45 of the report of the Committee on Fiscal Affairs entitled "Double Taxation Conventions and the Use of Conduit Companies" adopted by the OECD Council on November 27, 1986. Paragraph 43 of this report states, in part, "Existing conventions may have clauses with safeguards against the improper use of their provisions. Where no such provisions exist, treaty benefits will have to be granted under the principle of "*pacta sunt servanda*" even if considered to be improper." The more recently amended paragraph 22.2 of the Commentary states: "[T]here is agreement that Member countries should carefully observe the specific obligations enshrined in tax treaties to relieve double taxation as long as there is no clear evidence that the treaties are being abused." And paragraph 9.4 reads, in part: "[I]t is agreed that States do not have to grant the benefits of a double taxation convention where arrangements that constitute an abuse of the provisions of the convention have been entered into."

So what guidance is there regarding what is "an abuse of the provisions of the convention"? While there is some, it is not expansive.

Paragraph 9.5 of the OECD Commentary states:

> It is important to note, however, that it should not be lightly assumed that a taxpayer is entering into the type of abusive transactions referred to [earlier in the Commentary]. A guiding principle is that the benefits of a double taxation convention should not be available where a main purpose for entering into certain transactions or arrangements was to secure a more favourable tax position and obtaining that more favourable treatment in these circumstances would be contrary to the object and purpose of the relevant provisions.

So, this OECD "guiding principle" is that there are two factors to be considered:

> (i) Is a main purpose for entering into the transactions or arrangements to secure a more favorable tax position?
>
> (ii) Is obtaining that more favorable treatment contrary to the object and purpose of the relevant treaty provisions?

Paragraph 27 of the 2011 UN Model Tax Convention Commentary under Article 1 states:

> In order to minimize the uncertainty that may result from the application of that approach [i.e., paragraph 9.5 of the OECD Commentary], it is important that this guiding principle be applied on the basis of objective findings of facts, not solely the alleged intention of the parties. Thus, the determination of whether a main purpose for entering into transactions or arrangements is to obtain tax advantages should be based on an objective determination, based on all the relevant facts and circumstances, of whether, without these tax advantages, a reasonable taxpayer would have entered into the same transactions or arrangements.

As will be recognized from these two quoted passages, while these two commentaries from the OECD and the UN clearly allow the denial of treaty benefits in the event of treaty abuse, they suggest that a country's tax authorities should only do so after crossing a high threshold.

A principal point from this discussion is that if a country wants to clearly eliminate certain tax-motivated use of its treaty network, then it should put in place effective domestic anti-avoidance provisions and/or renegotiate its treaties to include treaty articles that accomplish its goals. See also paragraphs 8 – 103 of the Commentary under Article 1 of the 2011 UN Model Tax Convention; Part I, "Restricting the entitlement to treaty benefits" of <u>2002 Reports Related to the OECD Model Tax Convention, No. 8</u>, Organisation for Economic Co-Operation and Development, 2003; pages 36-37 of <u>Basic International Taxation (Second Edition), Volume One, Principles of International Taxation</u>, by Roy Rohatgi, BNA International Inc., 2005; and paragraphs 22, 8, and 7, respectively, of the Commentary to Articles 10, 11, and 12 of the OECD Model Tax Convention.

Limitation on benefits

The above discussion has assumed in several places that there is no "limitation on benefits" provision in any relevant tax treaty. In brief, a "limitation on benefits" article in a treaty will generally limit applicability of that treaty's benefits to taxpayers that meet not only the residency rules of the treaty but also certain additional objective requirements. For non-individual taxpayers, these requirements often focus on factors such as public ownership on one of several designated stock exchanges, a minimum level of local ownership, a minimum level of local expenditures, or a locally conducted active business. The existence of a "limitation on benefits" provision in a treaty may well defeat the attempt by the IC entity in the above simple example (back-to-back loan) to secure the desired treaty benefits.

As recently as twenty years ago, there were relatively few tax treaties that included "limitation on benefits" provisions. Increasingly, though, many countries have been actively renegotiating their portfolio of tax treaties to insert such provisions. For example, on 25 August 2010, Japan signed a new treaty with the Netherlands that includes a "limitation on benefits" provision. And on 21 May 2010, Japan and Switzerland signed a protocol amending their existing 1971 treaty to include such a provision along with many other amendments. Both of these treaty developments generally became effective from 2012. It may of course be noted that both the Netherlands and Switzerland have been important ICs for investment into Japan.

It may be noted as well that the 5 October 2015 Final Report on BEPS project Action 6, "Preventing the Granting of Treaty Benefits in Inappropriate Circumstances", includes the recommendations of a "principal purpose test" and a "limitation on benefit" provision. The Action 15 ("Developing a Multilateral Instrument to Modify Bilateral Tax Treaties") "Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting", released on 24 November 2016, includes both of these provisions in Part III. As ratification and implementation of the Multilateral Convention takes place over the next several years, "limitation on benefits" provisions and "principal purpose tests" may often be applicable, thereby strengthening the hands of tax authorities and discouraging the more blatant forms of treaty shopping.

Examples of IC entities in profit shifting and other structures

Within the "Differences between branch and subsidiary taxation" portion of Section M, there was some discussion of certain 2010 changes made to Article 7 of the OECD Model Tax Convention that affect the calculation of profit attributable to a permanent establishment. It was noted that the amended language of Article 7 will likely be slow to enter into new and newly amended tax treaties. It was also noted that the changes tend to reduce calculated income attributable to a permanent establishment in comparison to treaties that either have not been updated or that follow the United Nations' Model Tax Convention.

Assume that a home country/host country treaty has not been updated to reflect the 2010 Article 7 changes, but that a convenient IC/host country treaty has been updated. To secure the lower host country branch taxation that would apply under the updated Article 7, a home country entity

forms an IC entity solely to operate a branch in the host country. Assume that the sole motivation is treaty shopping.

Generally, it would seem in practice that few host countries would question the legitimacy of such planning since the IC entity itself is conducting an active business (i.e., the branch operation within the host country). Having said that, though, because the beneficial tax result rests upon residency in the IC as defined within the IC/host country tax treaty, the IC entity must clearly be established and managed in a manner that supports the claimed residency in the IC. If IC residency is based on management and control or some similar factor, then the IC entity's facts must support this. Further, the facts must support that the IC entity is truly a principal in operating its own business. For example, the IC entity should not operate in any manner that suggests that it is only an agent or nominee for the home country entity. Further, it should include as active members of its board of directors persons who are clearly independent of the board of the home country entity. If such actions are not taken, then the host country authorities could potentially claim that the IC entity was not entitled to the IC/host country treaty benefits because of residency in the home country rather than in the IC.

The immediately preceding paragraph focuses on the host country. On the other hand, the home country's tax authorities may also have an interest in the profits generated in the IC entity. In addition to examining for potential residency of the IC entity in the home country, they could also examine the efforts that home country management and personnel make on behalf of the IC entity and its business. Depending on the facts, these authorities could potentially claim that these management and other activities carried out in the home country for the IC entity cause the IC entity to have a permanent establishment in the home country. If so determined, then the IC entity would be directly taxable in the home country on the income attributable to that permanent establishment. As such, it is important that the facts support the IC entity's separate existence and independence from the home country entity. (Note that in the event that the home country maintains CFC legislation, the profits of the IC entity might also be taxed currently in the hands of the home country entity that owns the IC entity.)

The above several paragraphs focus on an example where an IC entity maintains branch operations in a host country. Over the past several decades, an increasing number of MNEs have set up supply chain and other structures with an intention of earning zero or very low-taxed income. Often, the principal company in such structures will be an IC entity that either owns or has licensed rights to intangibles that allow it to manufacture branded-products, or have them manufactured through contract manufacturers. Further, such an IC principal company, often termed an entrepreneur, will sometimes have few if any employees and contractually carry all commercial risk by operating through related party service providers, manufacturers, and distributors/commissionaires/agents based on limited-risk agreements. These agreements place relatively low levels of income in the related parties (often using cost-plus pricing for service and contract manufacturer agreements) and the bulk of the commercial risks and profits in the IC principal company. Where the parent company in the MNE group conducts important business functions of the IC principal company, the group's home country may have a strong case that the IC principal company is either resident in the home country (where that country applies a management and control residency rule) or should be considered to conduct business in the home country through a permanent establishment and be taxable by the home country on

any income attributable to that permanent establishment. The manner in which the various group members conduct their worldwide business may also create a partnership for tax purposes, which can again create taxation in the home country. See the following series of articles on this general area: "Attacking Profit Shifting: The Approach Everyone Forgets", Jeffery M. Kadet, 148 Tax Notes 193 (2015) (available at http://ssrn.com/abstract=2636073); ''Profit-Shifting Structures and Unexpected Partnership Status,'' Jeffery M. Kadet and David L. Koontz, Tax Notes, Apr. 18, 2016, p. 335 (available at http://ssrn.com/abstract=2773574); ''Profit Shifting: Effectively Connected Income and Financial Statement Risks,'' Thomas J. Kelley, David L. Koontz, and Jeffery M. Kadet, 221 J. Acct. 48 (Feb. 2016). (available at http://ssrn.com/abstract=2728157); and "Profit-Shifting Structures: Making Ethical Judgments Objectively," Jeffery M. Kadet and David L. Koontz, Tax Notes, June 27, 2016, p. 1831, and July 4, 2016, p. 85. (available at http://ssrn.com/abstract=2811267 and http://ssrn.com/abstract=2811280).

P. Tax treaties

Introductory comments

This Section P of the course paper provides some comments on tax treaties generally and on researching tax treaty issues. While it does not include any coverage of specific tax treaty articles, it does comment briefly on certain selected issues regarding the ability to claim treaty benefits. The specific OECD Model Tax Convention articles, and in some cases the UN and US Model Tax Convention articles as well, will be discussed in some detail in class. For good written discussion of the specific articles, see pages 112 through 193 in Basic International Taxation (Second Edition) Volume One: Principles of International Taxation (Roy Rohatgi, BNA International Inc., London, 2005).

The student is required to read the entire OECD Model Tax Convention (it's pretty short) and familiarize himself or herself with content of the Commentary on this Model Tax Convention (see the Required/Recommended Reading handout for specific portions of the Commentary that must be reviewed in more detail). These items are available either in hard copy in the law library or in soft copy through the OECD iLibrary database to which our UofW library subscribes. It is suggested that you download from OECD iLibrary the 30 October 2015 Full Version of the Model Tax Convention that includes both the Model Tax Convention itself as well as the Commentary as of 15 July 2014. (It is easily found by searching on the OECD iLibrary website for "Model Tax Convention" on the "books" page.) This Full Version has in addition considerable additional material including a number of other OECD publications mentioned in the "Required and Recommended Reading" handout. You may also easily find the OECD Model Tax Convention and Commentary as well as the UN and US versions on the Bloomberg BNA website, to which you have access through our library.

It is also recommended that you familiarize yourself with the www.oecd.org website since there are a number of items on this site relevant to tax treaties that are not found in the OECD iLibrary database. For example, at http://www.oecd.org/dataoecd/20/36/41031455.pdf, you may find the 17 July 2008, OECD "Report on the Attribution of Profits to Permanent Establishments". This

document gives significant background to changes in Article 7 of the OECD Model Tax Convention that were subsequently added to the Model in 2010. There are many other useful and relevant items available on this www.oecd.org site.

During the course, we will cover in detail many of the provisions found in model tax treaties, and the student will refer to specific country tax treaties as assignments or as part of case studies. Specific tax treaties may be easily found within the Tax Analysts on-line database that is accessible through www.lexis.com, to which students have access.

Tax treaties – benefits and characteristics

In general, a tax treaty is an agreement between two countries (termed herein "contracting states" and, depending on context, also referred to herein as "home state", "host state" and "source state") that regulates the taxation of each other's residents for certain types of income as specified in the treaty. Tax treaties are negotiated by appropriate officials of each country, are signed by both contracting states, and then only become effective upon ratification by the appropriate legislative or other authorized body in each country and the required exchange of instruments of ratification. Note in particular that taxpayers, despite their being affected by tax treaties, are not parties to those tax treaties. The only parties to a treaty are the contracting states.

In general, the benefits of tax treaties to a contracting state and its residents include:

- Exemption or reduction of host/source state taxation,
- Prevention of double-taxation through exemption by the home state of income earned in the host/source state, or the allowance by the home state of a tax credit for taxes paid to the host/source state,
- Increased certainty for taxpayers and the respective contracting states of the specific tax treatment of income/transactions covered by the treaty,
- Greater consistency of taxpayer treatment by the contracting states due to their mutual agreement on various definitions and source rules,
- A mechanism for resolving disputes between the contracting states regarding the taxation of specific taxpayers, and
- A mechanism for the exchange of information between the authorities of the contracting states

Note that the last two bullet points have been included in the BEPS project and other recent efforts by the G-20 and the OECD regarding improved administration and effectiveness of international taxation matters. See Action 14 "Making Dispute Resolution Mechanisms More Effective" in the section on the BEPS project and access information on exchange of information and the Common Reporting Standard at http://www.oecd.org/tax/automatic-exchange/. See also

Action 5 "Countering Harmful Tax Practices", which includes certain best-practice recommendations for the exchange of taxpayer-specific rulings with other tax authorities.

While the details included in each treaty will vary to some extent, tax treaties typically follow a set pattern. As such, tax treaties will normally include provisions that:

- Define terms, e.g. resident, the geographical limits of each country for application of the treaty, permanent establishment (i.e. the minimum threshold for direct taxation by the host state of defined categories of income earned by a resident of the home state), dividend, interest, royalty, air and sea international traffic, etc.,

- Determine which contracting state or states may tax exclusively or non-exclusively (or which contracting state is precluded from taxing at all) various categories of income, e.g. business income, income from real property, compensation, dividends, interest, royalty, etc.,

- Set maximum gross tax rates in the source state on certain of those categories of income, in particular, on dividends, interest, and royalties,

- Define source of income, e.g. royalty or interest being generally sourced based on the country of residency of the payer of the royalty or interest,

- Prevent double-taxation of the same income, normally through either an exemption approach or a foreign tax credit approach,

- Provide a mechanism for dispute resolution, i.e., competent authority procedure, and

- Provide a mechanism for the exchange of information between the two contracting states.

In addition to the above, an increasing number of treaties include a "limitation on benefits" provision to prevent treaty abuse (e.g. treaty shopping). See further discussion on this in the "Intermediate country" portion of Section O above as well as in the discussion below under the heading "Persons allowed the benefits of tax treaties". See also the BEPS project section later herein concerning Action 6, "Preventing the Granting of Treaty Benefits in Inappropriate Circumstances".

Matters tax treaties do not cover

There are plenty of topics and issues that tax treaties generally do not cover, thereby leaving them to the domestic law of the relevant contracting state. For example, tax treaties typically do not deal specifically with corporate reorganizations. However, there of course can be capital gain realized by a resident of one contracting state from an exchange of shares or the receipt of assets in the other contracting state that occurs as a part of a corporate reorganization. In such a case, it is possible that the capital gain article in the treaty may affect the taxation in that other country of the resident of the first state who realized the gain. Tax treaties also do not generally

cover the classification of entities (e.g. whether an entity is to be treated as a taxpayer or as transparent) or how "substance vs. form" issues are to be handled. These matters are normally left to local law.

Tax treaties generally do not cover taxes other than income and capital taxes. As such, they do not typically cover types of taxes and charges such as value added tax, gross receipts taxes, import duties and charges, stamp duties, real estate transfer taxes, etc. In addition, treaties might not cover local and provincial taxes (e.g. state and local taxes in the US and the inhabitants and enterprise taxes in Japan).

Application of domestic law and treaty provisions

It is important to say several things about the application of domestic law and treaty provisions.

- Treaty/domestic law conflicts—A first point is that the mere existence of a tax treaty that has been placed into effect by both contracting states through an exchange of instruments of ratification does not necessarily mean that the treaty's provisions will govern a particular taxpayer or transaction. In other words, there may be a conflict between domestic law and a treaty provision with the former overriding the latter.

  Countries can have differing approaches on how their domestic law and their international treaty obligations interrelate. In some countries, the terms of a tax treaty will always override domestic law. In others, a conflicting domestic law that was enacted after the treaty went into effect will override the treaty. Some countries will, on occasion, pass a new domestic law that, by its terms, expressly overrides existing treaty obligations. The US has been well known for doing this. Two clear examples are Internal Revenue Code section 7874 (limiting the benefits of corporate inversion transactions; see subsection (f)) and section 897 (taxing dispositions of US real property; see subsection (c) of section 1125 of the Omnibus Reconciliation Act of 1980, P.L. 96-499).

  Related to this area of treaty/domestic law conflict, there has been controversy in some countries regarding whether domestic anti-avoidance rules and judicial concepts such as "substance over form" can override the terms of treaties that would otherwise apply to provide tax benefits. Some newer treaties will include a provision stating that the contracting states may apply their domestic anti-avoidance rules to deny treaty benefits. An example of such a provision is found in Article 26 of the China/Singapore treaty:

  > Nothing in this Agreement shall prejudice the right of each Contracting State to apply its domestic laws and measures concerning the prevention of tax avoidance, whether or not described as such, insofar as they do not give rise to taxation contrary to the Agreement.

  See further discussion of this general topic in the portion of Section O headed "What is a legitimate IC entity use? How do tax authorities attack the use of IC entities?" Note also Part III of the "Multilateral Convention to Implement Tax Treaty Related Measures to

Prevent Base Erosion and Profit Shifting", released on 24 November 2016, which will add a principal purpose test and/or a limitation on benefits provision to many tax treaties.

- Treaty/domestic law interaction—A second point is that treaties, being broadly drafted, must interact within the framework and specific provisions of a country's domestic law. This point is in contrast to the first point above that focuses on treaty and domestic law conflicts. This type of interaction is best illustrated through several examples.

  - Say that corporate resident X of contracting state A transfers funds to its wholly owned subsidiary Y, a company that is resident in contracting state B. This transfer is based on a written loan agreement that provides for Y to make periodic interest payments to X and a balloon principal payment to be made upon demand by X. Before the tax treaty can be applied to determine the proper withholding tax on the payments to be made under this agreement, the domestic law of the B must first be applied to determine the true character of this arrangement for tax purposes. If it is determined that the agreement is, in fact, a loan, then the periodic payments would be treated as interest and the treaty article on interest would apply to determine the withholding tax on the gross interest payments. On the other hand, if B's domestic law treats the agreement as being preferred shares (or some other equity instrument) for tax purposes, then the treaty article on the taxation of dividends would apply to determine the withholding tax on the periodic payments. Domestic law would also apply to determine the character of the principal payment when made. For example, if B were the US, then it is possible that the US tax rules (Subchapter C of the Internal Revenue Code including section 302(d) in particular) would cause part or all of the balloon payment to be treated as a distribution taxable as a dividend rather than as a non-taxable return of capital. In such a case, the treaty would be applied to limit the level of withholding tax on the portion of the payment treated as a dividend.

  - Say that an individual resident of one contracting state is both a director of a corporation and an officer of that corporation. Say that he is earning both directors' fees and salary, respectively, for his two positions with the corporation. Since the respective treaty articles on directors' fees and employment income do not define either term, it is necessary to look to local law to determine how much of each type of income the resident is being paid. Only after so doing can the relevant treaty articles be applied.

  - Say that you have examined the activities of a resident of one contracting state within the other contracting state and you conclude, based on the definition of permanent establishment (PE) in the treaty, that the resident does have a PE in the other contracting state. Although there are some general rules in the "business profits" article in the treaty for determining the profits attributable to a PE, it will normally be necessary to go into the local tax rules to get more detail on how to compute this number. See, for example, Treasury Regulation section 1.861-8 in the US rules.

- Say that a resident X of country A owns shares in a country B corporation Y. Y purchases for cash some of its shares that are held by X. B domestic law will determine whether the transaction is to be considered the sale of a capital asset or alternatively a distribution with respect to the shares. As a sale of a capital asset, X will realize gain or loss equal to the cash paid to X less X's tax basis in the shares. As a distribution with respect to shares, X will normally be considered to have received a dividend to the extent of retained earnings (or earnings and profits in case B is the US). In the former case, the capital gain provision in the A/B tax treaty would govern the taxation of X by B. In the latter, the dividend provision would apply. (See Internal Revenue Code section 302 for an example of this issue.) The taxation of X by A (the country of residence) will have a similar issue between characterizing the transaction as a sale of a capital asset or as a distribution with respect to shares. If A treats X as having received a dividend and assuming A does not exempt its residents on foreign source income, then A's foreign tax credit rules may allow X to claim an indirect foreign tax credit. It may occur that the two countries will apply different characterizations. Likely, only if X has been subjected to double-taxation and has sought competent authority relief might the characterization by one country be changed so that the characterizations match and double-taxation is avoided.

Research and interpretation of tax treaty Issues

Unlike the research of most domestic tax issues where various publishers provide comprehensive resources for practitioners, comprehensively researching tax treaty issues can cause the practitioner to find himself or herself looking far and wide among disparate and obscure sources published in various countries around the world. Sometimes, it can be akin to searching for a needle in a haystack. With this in mind, see in the course website several bibliographies of resources.

In this brief discussion concerning the research and interpretation of tax treaty issues, we will mention the following resources:

- The "Vienna Convention on the Law of Treaties" ("VCLT")
- The Commentary of the OECD Committee on Fiscal Affairs ("Commentary") to the Model Tax Convention on Income and on Capital ("Model Tax Convention") published by the Organisation for Economic Co-operation and Development ("OECD")
- Commentary on the Articles of the 2011 United Nations Model Double Taxation Convention Between Developed and Developing Countries (respectively, "UN Commentary" and "UN Model Tax Convention")
- Protocols, technical explanations and other documents issued by contracting states
- Rulings and court decisions concerning tax treaty issues published unilaterally by the relevant tax authorities and courts in various countries

The VCLT provides a base for treaty interpretation that the courts of many countries have acknowledged whether or not the country is or is not a signatory to it. A copy of this convention has been included in the course website and can be separately found at http://untreaty.un.org/ilc/texts/instruments/english/conventions/1_1_1969.pdf. At a minimum, it is suggested that you read VCLT Articles 26-33, 42(2), 46, and 60-64.

The OECD Model Tax Convention, as issued and amended from time-to-time by the Committee on Fiscal Affairs, has been the format from which many bilateral tax treaties have been negotiated. Supporting this Model Tax Convention is the Commentary, which explains in reasonable detail many of the provisions in the Model Tax Convention as well as negotiating alternatives that contracting states might choose during their treaty negotiations. As mentioned earlier herein, you may find in our law library hard copies of the Full Version of the Model Tax Convention and Commentary. Again, as noted earlier, you also have access to a soft copy of these documents through the UofW library's subscription to OECD iLibrary.

Note that the Commentary is written to provide guidance to treaty negotiators. As such, through out the document, there is discussion of alternative treaty language and negotiating positions and their consequences. Because the Commentary has so much detail and is also made available to the public at large, it has become an important source for interpreting treaties, relied upon by governments and taxpayers alike. The fact that it provides common ground for the negotiators of both countries gives its content significant credibility when a taxpayer attempts to use that content to support its application of a tax treaty.

Where the language of a particular tax treaty is the same or similar to that found in the Model Tax Convention, courts have looked to the Commentary for guidance. You should spend some time looking through this document to see what it contains. It will also be useful in some of our class discussion.

The UN Model Tax Convention and the UN Commentary are very similar documents to what the OECD has issued. However, the focus includes more the interests of developing countries in contrast to the OECD's documents that are focused more from the perspective of developed countries. Depending on the particular treaty that one is dealing with and its specific language, these UN documents may be helpful and relevant. The most recent version of the UN Model Tax Convention and UN Commentary is termed the 2011 Update and was released on 15 March 2012. A copy is available at:
http://www.un.org/esa/ffd/documents/UN_Model_2011_Update.pdf

The contracting states for a particular treaty may have agreed on various matters that have not been included in the tax treaty language itself. Such agreed matters may be included in a protocol to the treaty or in other documents exchanged by the contracting states. Such protocols and documents may have been agreed and issued at the same time that the treaty was ratified or they may have been agreed and issued later. In any case, the important point is that when reviewing a treaty for a particular issue, it is also necessary to look for any protocols or other documentation that exists and examine them for anything that may affect the issue you are researching.

The relevant authorities in some countries publish unilateral technical explanations and rulings on both general tax treaty issues as well as on specific treaties. The US, for example, publishes a technical explanation of its model treaty (United State Model Technical Explanation Accompanying the United States Model Income Tax Convention of November 15, 2006) as well as explanations of many of the specific treaties it has concluded with other countries. (Although an updated 2016 United States Model Income Tax Convention was released on 17 February 2016, no technical explanation has yet been released as of late 2016.) The US also publishes rulings, both public and private, on tax treaty issues. While it may happen that such technical explanations and rulings issued unilaterally by various countries have been provided to their respective treaty partners, these treaty partners and the courts therein would not likely treat these items as authoritative for interpreting the applicable tax treaty since they are not mutually agreed documents. They may, however, be helpful as persuasive tools.

Courts in various countries around the world have addressed tax treaty issues. In so doing, they sometimes will look to cases on the same issue that have been adjudicated in other countries. While such cases will seldom, if ever, be controlling, they can be influential or persuasive.

Considering the above two paragraphs, comprehensive research of a tax treaty issue where a definitive answer cannot be found within the particular contracting state's legal literature will involve looking to rulings and cases in other jurisdictions on similar or related issues. Sadly, conducting such a worldwide review can be difficult at best. With one exception, there appears to be no comprehensive source where such rulings and cases are published. The one exception is The International Tax Treaties Service, edited by Michael Edwardes-Ker and published by In-Depth Publishing Limited in England. A copy can be found in the library's reference section at K4504.15 1974. Unfortunately, this service is no longer published or updated. As a consequence of this, comprehensive research would likely involve a survey of counsel in other countries for the existence of any relevant local rulings or cases. A few years ago, the International Bureau of Fiscal Documentation (www.ibfd.org) initiated a Tax Treaty Case Law database. While this does not appear to be comprehensive as it includes items from only a limited number of countries, it should be a worthwhile resource. See http://www.ibfd.org/IBFD-Products/Tax-Treaty-Case-Law.

There are a number of books and articles that focus on various aspects of tax treaties and that can be very useful research tools. You should look at the bibliographic listings included in the course website. One interesting book included in our law library is Permanent Establishment—Erosion of a Tax Treaty Principle, by Arvid A. Skaar, (Kluwer Law and Taxation Publishers, 1991) (K4475.4 S42 1991). In addition to considerable detailed analysis of the permanent establishment concept, there is also interesting discussion on the historic development of tax treaties.

Persons allowed the benefits of tax treaties

While a surface view may indicate which person or persons in a particular factual situation will be allowed the benefits of an existing tax treaty, an in-depth review will normally be necessary to confirm the benefits desired.

Domestic law basis for definition of resident

With some exceptions, only "residents" as defined in a treaty (usually in Article 4) are entitled to the benefits of that tax treaty. While "resident" is a defined term, the definition typically refers to a contracting state's domestic law to actually determine a person's residency. While we in the US are accustomed to all citizens and domestic corporations being subject to worldwide taxation and therefore arguably residents, other countries often use different criteria (e.g. location of management and control). Accordingly, one cannot immediately assume that a citizen or domestic corporation of a contracting state is, in fact, resident in that contracting state for purposes of the treaty.

Regarding the US, this writer's understanding is that the US Treasury does not generally consider US citizens and resident aliens residing outside the US, despite their being subject to world-wide US taxation, to be US residents under any applicable treaty. As such, the US would not back up a claim by such an individual of treaty benefits against a US treaty partner. See (i) Article 4, paragraph 2 of the Japan/US tax treaty, and (ii) Article 4, paragraph 1 of the Canada/US tax treaty, both of which reflect this position. See also Treasury Regulation section 301.7701(b)-7 regarding coordination of resident alien status with income tax treaties where the resident alien concerned is also resident in the other contracting state under the treaty.

Residency in more than one country – Dual residency

It can occur, whether through bad or no planning or through intentional planning, that a person (e.g. individual or company) is a resident under the domestic tax laws of two countries. For example, a company X may be a resident of country A because it was organized under A's laws and a resident of country B because its management and control is located within B. Typically, X would be referred to as a "dual-resident". Many treaties include in paragraphs 2 and 3 of Article 4 "tiebreaker" provisions, both for individual and non-individual persons, to establish for purposes of the treaty's application which is the country of residence and which is not. For example, for a person other than an individual, the tiebreaker rule often provides that the state of residency will be "the state in which its place of effective management is located". This is the language used in both the OECD and UN Model Tax Conventions, though it should change in the next update of the OECD Model Tax Convention and likely in the UN Model sometime thereafter. The Final Report for Action 6 of the BEPS project, "Preventing the Granting of Treaty Benefits in Inappropriate Circumstances", in paragraphs 45 – 48 sets out the changes to paragraph 3 of Article 4 of the Model Tax Convention. Paragraph 3 will be amended to read:

> Where by reason of the provisions of paragraph 1 a person other than an individual is a resident of both Contracting States, the competent authorities of the Contracting States shall endeavour to determine by mutual agreement the Contracting State of which such person shall be deemed to be a resident for the purposes of the Convention, having regard to its place of effective management, the place where it is incorporated or otherwise constituted and any other relevant factors. In the absence of such agreement, such person shall not be entitled to any relief or exemption from tax provided by this

Convention except to the extent and in such manner as may be agreed upon by the competent authorities of the Contracting States.

This change, which is also reflected in Article 4 of the Multilateral Convention released 24 November 2016, recognizes that cases of dual residence often involve tax avoidance arrangements. As a result, the decision was made to require a case-by-case approach by the competent authorities to determine the country of residency for purposes of a tax treaty. Where there is no such determination, then as a default any non-individual taxpayer having dual residence would not be entitled to any tax treaty benefits.

There is little guidance on the meaning or application of the existing tiebreaker rule for persons other than individuals. Following certain 2008 updates to the OECD Commentary for Article 4, the available guidance in paragraph 24 is: "The place of effective management is the place where key management and commercial decisions that are necessary for the conduct of the entity's business as a whole are in substance made. All relevant facts and circumstances must be examined to determine the place of effective management. An entity may have more than one place of management, but it can have only one place of effective management at any one time." (See the OECD public discussion draft of "Draft Contents of the 2008 Update to the Model Tax Convention", 21 April 2008, pages 7ff.) This language on the meaning of effective management will be deleted from the OECD Commentary following the next update, though it seems likely that many tax treaties will continue using the existing tiebreaker rule. See new paragraph 24.5 of the Commentary in paragraph 48 of the 5 October 2015 Action 6 Final Report.

Commentary limitations on residency

In the discussion in Section O on Tax Effective Locations regarding the ability of a source country to attack an IC (intermediate country) entity for treaty shopping, mention was made of the provision in some treaties of a limitation on the definition of resident. In brief, this limitation can treat a foreign-owned resident of one contracting state as being non-resident for purposes of the treaty if that resident is taxed in its home state only on income from sources in that home state. See the second sentence of paragraph 1 of Article 4 of the Model Tax Convention and paragraph 8.2 of the Commentary on Article 4.

The 2008 changes to the Commentary on Article 4 have expanded paragraph 8.2 to clearly cover the following additional situation. This expansion emphasizes the danger of merely assuming, without carefully checking, that a person that is resident under a country's domestic tax law will be resident for purposes of any or all of that country's treaty network. Say that X is a tax resident of country A under its domestic law (say due to its country of incorporation) and that A imposes worldwide taxation on its residents. X is also resident in country B under its domestic law (say because of management and control being located in B), making X a "dual-resident" of A and B. Under the tiebreaker provision of a treaty between A and B, X is determined for purposes of this treaty to be tax resident in B (i.e., its place of effective management is within B—see existing paragraph 3 of Article 4 before any change described in paragraphs 45 – 48 of the 5 October 2015 Action 6 Final Report). As a result, X is not subjected by A to tax on its worldwide income; rather, A taxes X solely on A sourced income.

Assume that X has income from sources in country C that is taxable in C under its domestic law. Further, assume that there is a treaty between A and C and that the tiebreaker provision of this treaty is not applicable because X is not resident in C under either its domestic law or paragraph 1 of Article 4 of the A/C treaty. Assume as well that X would benefit from a reduction or exemption in C taxation if it were considered a resident of country A under the A/C treaty. The expansion in Paragraph 8.2 of the Commentary on Article 4 provides that because X is not subject to A's world-wide taxation due to the A/B treaty, X cannot be a resident of A under the A/C treaty. As such, the otherwise applicable reduction or exemption from tax in C could not be claimed. (See also the amended language in paragraph 1 of the Commentary on Article 21 as well as the OECD public discussion draft of "Draft Contents of the 2008 Update to the Model Tax Convention", 21 April 2008, pages 9ff.)

Triangular cases

Another area where complications arise in tax treaty coverage is "triangular cases". For example, say that a Japanese bank with a branch in Singapore loans funds from that branch to a borrower in Malaysia. Although the Japan/Malaysia tax treaty may technically apply, there can be legal and practical difficulties in attempting to claim treaty coverage in Malaysia to reduce that country's domestic withholding tax. See the report "Triangular Cases" issued by the OECD Committee on Fiscal Affairs and approved by the OECD Council on 23 July 1992. See also paragraphs 69 – 72 of the Commentary under Article 24 of the OECD Model Tax Convention.

Transparency – Partnerships and LLCs

An area of particular difficulty involves the ability of partnerships and their partners to claim treaty benefits. While many countries recognize partnerships to be transparent for tax purposes, some treat them as taxable entities with their partners being treated more like shareholders. Especially where two treaty countries treat partnerships differently, treaty benefits can potentially be denied to residents even when economically they should be granted. Additional complications can of course arise when three (or more) countries are involved with the partners being in one or more countries, the partnership being established in another country, and the partnership earning income or conducting business in some other country (i.e., the host/source state). Further, even if two contracting states treat partnerships similarly as being transparent, they may have differing domestic laws on how various partnership items are treated. As indicated in a bullet point in Section H in regard to interest on a loan made by a partner to a partnership, one contracting state may treat such interest as actual interest and apply the treaty's interest sourcing rules while the other contracting state treats it as a special allocation of partnership income, thus causing different sourcing.

The OECD Committee on Fiscal Affairs has examined this particularly complicated area in its report "The Application of the OECD Model Tax Convention to Partnerships". This report was adopted on 20 January 1999 and certain recommendations were later adopted into the OECD Model Tax Convention Commentary. See in particular paragraphs 2 through 6.7 under Article 1 in the OECD Commentary. (You will find a copy of this OECD report in the 2014 soft copy

edition of the OECD Model Tax Convention and Commentary that was issued 30 October 2015. This document begins on page 1719 of the pdf file.)

In addition to partnerships that can be treated as transparent or as a separate entity taxpayer, other entities, in particular the limited liability company, may be similarly treated as transparent or as a separate taxpayer. When two or more countries treat such an entity differently, it will often be termed a "hybrid entity". With the exception of some more recent treaties, most tax treaties are silent with respect to how partnerships and hybrid entities are to be treated. Note that the available OECD guidance, which is not binding on local tax authorities, is limited to partnerships and does not cover hybrid entities. Some more recent treaties include rules that deal with partnerships and hybrid entities. See, for example, Article 4, paragraph 6 of the 2003 Japan/US tax treaty and Article 4, paragraph 5 of the 2010 Japan/Netherlands tax treaty as well as Article 1, paragraph 6 of the US Model Tax Convention.

Article 3 of the Multilateral Convention released 24 November 2016 includes rules for transparent entities that should resolve uncertainties involving such entities in future years as the Multilateral Convention is ratified and goes into effect for some specific bilateral tax treaties. In brief, Article 3 provides that income earned by or through transparent entities can be income of a resident of a treaty country, but this is only to the extent that the income is treated as the income of a resident of that country under that county's tax rules. The same rule will be included in the next version of the OECD Model Tax Convention, which is expected to be published in 2017.

Domestic notification and rules preventing treaty shopping

For treaty coverage to apply, for example, in the case of exemption from or a reduced withholding tax rate on payments of dividends, interest or royalty to a non-resident, the country of the payer may require that the non-resident treaty-protected recipient obtain a certification of residency from its home government and/or submit a treaty relief form prior to the payment. Any such requirements are generally meant to establish that the non-resident recipient is, in fact, entitled to treaty relief. Because of this kind of requirement, it is important that a parent company recipient of such payments not order their subsidiary to make immediate payment of such amounts prior to checking on any such certification and filing requirements (or, where relevant, on exchange control or other requirements).

An increasing number of countries have instituted not only such certification and notification requirements, but also "substance over form" and similar rules that seek to prevent mere agents or nominees and other "conduits" from securing treaty benefits. China and Indonesia are two good Asian examples of this expansion of efforts to prevent treaty abuse.

Limitation on benefits provisions

Another growing aspect is the expansion of "limitation on benefits" clauses that can prevent treaty benefits from applying to otherwise qualifying resident taxpayers. While pioneered by the US, a number of countries have been inserting such provisions into their newer treaties or through protocols into their existing treaties. Japan, for example, has inserted such provisions

into its recently negotiated and amended treaties with the Netherlands and Switzerland. As noted earlier, the BEPS project will likely cause many more treaties to have such “limitation on benefits” clauses in the future. In this regard, note Part III of the “Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting”, released on 24 November 2016, which will add a limitation on benefits provision to many tax treaties.

In brief, where a “limitation on benefits” clause exists, some treaty benefits will be denied to an otherwise resident company owned by non-treaty country residents or where the company’s expenses are paid mostly to non-resident recipients. The rules under some such clauses can be relatively complicated with various percentage tests as well as an active business exception. Some such provisions will also deny treaty benefits where income is earned by the resident through a permanent establishment in a third country that is not fully taxed in the country of residence.

Territorial basis – Received requirement

As a final issue in this section on persons who may benefit from tax treaties, it is important to note a peculiarity of some countries that tax their residents on a territorial basis or on a “received in country” basis. Residents of such a contracting state might only obtain the benefits of the treaty in the other contracting state to the extent that they actually are taxable on the same income in the contracting state of which they are residence. As an example of this, Singapore has a partial territorial taxation system under which a Singapore resident will only be taxable on foreign source income if that income is received in Singapore. Say that a Singapore resident earns interest income from a Japanese resident. Under the Singapore/Japan tax treaty, the reduced withholding rate on interest under the treaty will only apply if the Singapore resident receives the interest in Singapore and declares it as taxable income in Singapore. If the Singapore resident leaves the income outside Singapore and untaxed in Singapore, then the domestic Japanese withholding rate, and not the lower treaty rate, will apply. The following is from Article 22, paragraph 1 of the Singapore/Japan tax treaty: “Where this Agreement provides (with or without other conditions) that income from sources in Japan is exempt from tax or taxed at a reduced rate in Japan and under the laws in force in Singapore, the said income is subject to tax by reference to the amount thereof which is remitted to or received in Singapore and not by reference to the full amount thereof, then the exemption or reduction of tax to be allowed under this Agreement in Japan shall apply only to so much of the income as is remitted to or received in Singapore.” Similar provisions will be found in some treaties entered into by the U.K., Malta, and Ireland. See also paragraph 26.1 concerning “Remittance based taxation” in the OECD Commentary on Article 1.

Q. General anti-avoidance and form vs. substance concepts

__Introductory comments__

Taxation is based on law and legal principles. As such, in determining the taxation of a person, all countries give considerable attention to the person(s) involved (i.e., individuals and legal entities) and the rights and obligations of each such person as defined by law (e.g. tax law, commercial code, civil law) or by contract (e.g. civil contracts, labor contracts).

To some greater or lesser degree, many countries in their concern about abusive tax-avoidance will also pay attention to the "substance" of transactions and relationships that several persons have. A transaction or series of transactions may have been characterized for tax reporting purposes by the participants in one manner. However, if the terms of one or more agreements between these persons reflect an economic substance that is different from or inconsistent with the participants' characterization of the transactions and relationships, then the tax authorities of the relevant country or countries may attempt to re-characterize the transactions to reflect that economic substance.

Various countries have within their statutory law or judicial precedents various anti-avoidance mechanisms for dealing with this "form vs. substance" issue, with civil law countries more typically having statutory rules and with common law countries often having judicial precedents and sometimes statutory rules as well. For example, in the US, a common law country, judicial precedent has created over many years certain overlapping tools that the tax authorities have used with varying degrees of success in attacking a variety of structures and taxpayer planning. Such tools have included, for example:

- Substance-over-form (the substance, not form, of a transaction should determine tax consequences)

- Step transaction (multiple steps should be collapsed into one transaction to determine tax results)

- Sham transaction (a transaction having no purpose other than achieving particular tax results should be disregarded for tax purposes)

- Business purpose (a transaction that in form is business-related should not be honored if it lacks a non-tax purpose)

- Economic substance (a transaction lacking economic substance, looking to both objective and subjective criteria, should not be honored)

(This listing of overlapping tools was taken from "Legislative and Regulatory Responses to Tax Avoidance: Explicating and Evaluating the Alternatives", by Erik M. Jensen (56 St. Louis U. L.J. 1 (2012).)

In 2010, the last two of these listed tools were codified in Internal Revenue Code section 7701(o), which effectively forced courts throughout the US to adopt a consistent approach of requiring that both parts of a two-pronged test be met for a transaction to be respected as having "economic substance". In brief, a transaction is treated as having economic substance only if (1) the transaction changes in a meaningful way (apart from Federal income tax effects) the taxpayer's economic position, and (2) the taxpayer has a substantial purpose (apart from Federal income tax effects) for entering into the transaction. These two prongs represent an "objective" test where the objective effects of a transaction on the taxpayer's economic position can be considered and a "subjective" test where the intent and motives of the taxpayer can be examined. Along with this codification in 2010, a potentially severe penalty was added for transactions that fail this new codified economic substance doctrine. This penalty, although at a lower rate, will apply even if the transaction is adequately disclosed to the US tax authorities. Further, the penalty cannot be avoided because a taxpayer relied on advice of counsel. This aspect means that tax advisors themselves are more at risk of potential malpractice claims if, for example, planning they've developed or have opined favorably on is questioned and penalties are imposed on the client taxpayer.

Note that the first three of the above listed judicial "tools" (substance over form, step transaction, and sham) apply to establish the proper characterization of transactions for determining the tax consequences of those transactions. For example, should a transfer of property under a lease agreement be characterized for tax purposes as a true lease or as a sale? Or, should a liquidation of a corporation followed by the incorporation of a new corporation that conducts the same business be treated as two separate events or should they be "stepped together" such that for tax purposes nothing had occurred? On the other hand, the business purpose and economic substance tools, now codified in section 7701(o) under the "economic substance" label, focus on how a properly characterized transaction meets or fails the "objective" and "subjective" tests outline above. This implies an order of application of these tools. Thus one or more of the first three judicial tools must be applied first to establish the proper characterization for tax purposes of one or more transactions. Only after a proper characterization is established can the new codified "economic substance" rule be applied. If under the new rule the transaction as properly characterized fails either of the section 7701(o) tests, then certain heavy penalties can apply to the taxpayer.

From a very practical perspective, applying statutory or judicially based anti-avoidance rules is not an easy matter. For the US, whether prior to enacting section 7701(o) or subsequently, there has been and will continue to be significant controversy and difficulty in knowing when any of the above-mentioned tools will apply. In the UK on 1 August 2011, the government published a technical note on a proposed anti-avoidance rule focused on tax treaty abuse. However, the proposed rule was withdrawn within two months with the government spokesman saying: "The responses so far received have made it clear that the proposed legislation, as drafted, could cause significant uncertainty for compliant UK businesses and overseas investors about its intended scope and its practical effect…. The government are committed to providing certainty to taxpayers and acknowledge the concerns raised in the responses to the consultation. They have therefore decided not to proceed further with the consultation on the proposed legislation and will not include it in the Finance Bill 2012." Subsequently on 12 June 2012, the UK government published a "Consultation Document" proposing what it believes will be a "General

Anti-Abuse Rule" (GAAR) more narrowly targeted at artificial and abusive tax avoidance. This more targeted GAAR was included in the Finance Bill 2013.

On 12 July 2016, the European Council adopted an anti-tax avoidance directive to address aggressive corporate tax planning. The directive includes a general anti-abuse rule, which member states have until 31 December 2018 to insert into their national laws and regulations. See http://www.consilium.europa.eu/en/press/press-releases/2016/07/12-corporate-tax-avoidance/.

For considerable discussion of anti-avoidance issues and their application by various countries around the world, see Volume 95a, "Tax Treaties and Tax Avoidance: Application of Anti-Avoidance Provisions" (2010), from the Cahiers de Droit Fiscal International series published by the International Fiscal Association.

Despite the 2013 – 2015 BEPS project's overall focus on MNE tax avoidance structures, the project did not include in its purview any consideration of an overall GAAR. Rather, focusing principally on treaty-shopping, Action item 6 included suggestions for a principal purpose test and some form of "limitation on benefits" under which treaty benefits could be denied by host and source countries. See the later section on the BEPS project and Section P above. It should also be noted that some countries, believing that the BEPS process will be too slow or insufficient in its coverage, have already taken unilateral action to counter BEPS behavior by MNEs based in other countries that have structured themselves to avoid local taxation in connection with sales or services directed at customers in these countries. Although such unilateral actions are not in the form of GAARs, they do seek to override the BEPS structures that MNEs are using. The U.K. and Australia are the two most well known examples of such unilateral action, and more recently, India has instituted an "equalization levy" directed at digital services, including online advertising.

Anti-avoidance mechanisms

The following brief listing of mechanisms used by some countries to attack questionable structures and aggressive taxpayer planning is from page 25 of a 2009 OECD book titled Building Transparent Tax Compliance by Banks (footnotes have been omitted). The listing includes statutory general anti-avoidance rules as well as other statutory and judicial mechanisms.

- "Court decisions (especially in the jurisdiction of a parent company), including leading anti avoidance doctrines from *Furniss v Dawson* (United Kingdom) and *Coltec Industries v. United States*. In some countries there may not be a legal precedent to provide a clear definition of anti avoidance, anti abuse or where the structuring is deemed inappropriate.

- "General legal concepts which continue to evolve and which describe unacceptable effects of transactions common to most legal systems, such as Fiscal Nullity, Sham, *Abus de Droit* (France), *Fraus Legis* (Netherlands), Economic Substance (United States) and Misuse and Abuse (Canadian GAAR concepts). These concepts can cover both general legal and tax issues.

- "General anti-avoidance provisions such as those that exist in Australia (dominant purpose of avoiding tax), Canada (transactions not undertaken primarily for *bona fide* purposes that result in a tax benefit and a misuse or abuse of the provisions of the tax legislation), Ireland (primary purpose of producing a tax advantage where there is a misuse or abuse of the provisions of the tax legislation) and South Africa (sole or main purpose to obtain a tax benefit).

- "Published revenue body guidance, including 'black listed' transactions. (See, for example: https://www.irs.gov/Businesses/Corporations/Listed-Transactions.)

- "International law or double tax treaty applications. For example, international cases such as *Indofood International v JP Morgan Chase* involving the use of conduit companies in treaty countries to avoid withholding tax under double tax conventions."

Framework for analysis

Recognizing the diversity of various countries' anti-avoidance mechanisms for dealing with this "form vs substance" issue, a principal goal in this course paper is to provide you with a mechanism or framework that you can use to help analyze specific situations. With this in mind, consider the following categories:

Sham or fake transaction

The persons concerned are not following the terms of their contractual obligations and are in fact doing something different. This type of situation would normally be termed a "sham" or fake transaction and would be disregarded in most countries.

A simple example would be where a parent company in country A has contracted with its subsidiary in country B to perform certain services for the subsidiary. The contract, which states that the services are to be performed by the parent at its headquarters in A, is the basis for the payment by the subsidiary to the parent of certain service fees. Under B's laws, the payments are deductible to the subsidiary and are also free of withholding tax since the payment is for services physically performed outside of B. Assume that in actual fact, the parent performs no services and never intended to perform any. In this case, B would likely treat the contract as being a mere sham or fake transaction since the parties never intended to create an enforceable contract. As a result, B would re-characterize the payments in some manner based on its local law and practice. Some countries might simply disallow the deduction. Others might reclassify the payment as a dividend with the result that the deduction is disallowed and a dividend withholding tax is applied.

Note that in the US the term "sham" is sometimes used in a much broader fashion to mean any transaction the legal form of which is not respected for US tax purposes. This could include legally enforceable contracts that in this paper are covered in the several sections below.

Characterization of a single contract/corporate action

The person or persons concerned execute one contract or corporate action that is real and the terms of which they fully respect. However, the form of the arrangement and the documents chosen by the party or parties may differ from the form and documents that would normally be used to achieve the economic results intended.

A simple example is a lease agreement being executed over personal property where the economics inherent in the lease terms imply a full transfer of all significant rights of possession and ownership in the property from the one party (the lessor) to the other (the lessee). Another example is a loan from a parent corporation to its thinly-capitalized subsidiary. Does the transfer of funds represent for tax purposes true indebtedness or should it be considered equity? A further example is a wholly owned subsidiary acquiring for cash or other property its own shares from its sole shareholder. In this case, is the transaction for tax purposes a capital exchange of shares for cash or a simple distribution of cash with respect to shares that would be treated as a dividend to the extent of retained earnings within the subsidiary?

Where two or more persons are involved, they could be related or unrelated.

A good example of the type of analysis required for this "single contract/corporate action" category may be found in *NA General Partnership & Subsidiaries et al. v Commissioner*, T.C. Memo 2012-172, No 525-10, 19 June 2012. This case presented the issue of whether certain loan notes established in connection with a corporate acquisition were to be treated as debt or equity.

Characterization of multiple contracts/corporate actions

The persons concerned execute two or more real contracts and/or corporate actions that are all individually legitimate (although they may or may not individually be commercially reasonable or supportable) and the terms of which the persons fully respect. The net economic/legal results are what the persons desire, but these results could have been accomplished in some more direct fashion. The persons have presumably structured their multi-step approach, in part, because the tax effects of the individual steps are more favorable than the tax effects of the more direct approach.

One example is a back-to-back royalty arrangement where a parent corporation in the home country licenses intellectual property ultimately to its subsidiary in a source country through an intermediary country entity that has a more favorable tax treaty (i.e., lower royalty withholding tax) with the source country than the home country has. A second example would be a situation where three related companies sign three installation/construction contracts with one client in another country with the specific intention of avoiding a permanent establishment as defined in the tax treaty between the two countries. Assume the definition of permanent establishment in that treaty includes any installation/construction project that lasts more than twelve months. Each of the three contracts is structured so that each company's project will be completed within twelve months, thereby avoiding for each company a permanent establishment. The period over which all three contracts will be completed extends beyond twelve months so that had

there been just one contract covering all the work, there would clearly be a permanent establishment with resulting taxation of the profits attributable to that permanent establishment. (Regarding this second example, note that Article 14 (Splitting-up of Contracts) of the Multilateral Convention released 24 November 2016 will add a provision to many tax treaties specifically targeted at this type of situation.)

As a third example, look back to the Section G discussion of the engineering and construction project. That involved a major engineering and construction "turnkey" contract for the design and construction of a major chemical processing facility. There was discussion of possible planning to break this up into a number of contracts amongst several group companies and the unrelated client covering various services to be performed either inside or outside the client's country, personal property to be sold, intangible property to be licensed, etc. In regard to this, an issue raised was whether the client would agree to multiple contracts. The client might reasonably require a completion guarantee and/or other contractual mechanisms to provide comfort that the intended "turnkey" effect is achieved. Interestingly, an Indian case involving Ericsson included this issue (*DIT v. Ericsson Radio System A.B.*, Dehli High Court, 23 December 2011). In brief, the decision described the Indian tax authorities' assertion in paragraph 20:

> …It was the submission of Mr. Prasaran that a plain reading of the terms and conditions of the three contracts, all entered into on the same day and at the same place in India, viz., Bangalore, indicates that they are all interlinked, inter-twined and inseparable. He pointed out that the assessee and its associated sister concerns had entered into contracts with the Indian buyers for the setting up of a GSM system in India. For the aforesaid purpose, the hardware and software was to be supplied/licensed by the assessee, the installation through a sister concern of the assessee was to be overseen by the assessee and the overall responsibility of the three contracts also was upon the assessee. He drew our attention to the salient features of the three Agreements which according to him conclusively show that they are, in effect, one integrated business arrangement….

The "overall responsibility" included supervision and a performance guarantee.

Disregarding the tax authorities' position, the Delhi High Court stated in paragraph 45:

> Merely because the activities, namely, the supply activity and the installation activity are to be carried out by two separate Companies who are part of the same Group cannot result in the transaction being treated as one composite transaction. This is more so when both the entities perform their own independent obligations, receive appropriate separate remuneration and, as found by the Tribunal, are not financially or technically dependent on each other.

While the court did not support the Indian tax authorities in their view of the integrated nature of the three contracts and did not value highly the supervision and performance guarantees made by the overseas taxpayer (the "assessee" in the above quotations taken from the decision), judges having only a slightly differing view might have analyzed the same facts and decided that

the three contracts should be characterized as one integrated transaction such as the Indian tax authorities were arguing for. (Students wishing to read this case will find it on the "India" page in the Course Website.)

The persons involved in such multiple contracts/corporate actions could be related or unrelated. The above three examples involve related parties to some extent. A simple example where only unrelated parties are involved is a "sales and leaseback". For example, Corp X owns a factory in which its employees manufacture a product. As X requires financing for various corporate needs, it wants to borrow money. Assume that X has capital loss carry forwards that will expire soon if not used to offset realized capital gain. Lender Y is willing to lend, but wants to do so in a more tax efficient manner. So, rather than entering into a simple loan agreement, the two parties execute two agreements. Under the first agreement, X sells the real property to Y and Y pays X the full fair market value of the property. X reports capital gain, which is offset by the carry-forward losses. Effective from the date of sale, the second agreement leases the property now owned by Y to X so that X is able to continue using the factory in its business. The terms of this lease place all risks and burdens of ownership on X as lessee and further provide X a purchase option with a nominal strike price. As a result of now "owning" the property, Y reports rental income and offsets this rental income with accelerated depreciation, thereby reporting in the early years of the lease losses that it utilizes to reduce its overall taxable income.

Characterization of multiple circular contracts/corporate actions

Persons will, on occasion, enter into multi-step circular transactions that have little or no economic effect on the parties (aside, perhaps, from the real cost of the tax scheme promoter), but which create some tax benefit.

One example is a liquidation/re-incorporation transaction where a loss subsidiary conducting an active business is liquidated with the active business assets, net of liabilities, being contributed to a new subsidiary. The tax goal is to recognize a loss at the parent company level from the liquidation. This type of transaction might also be initiated to secure a "re-freshed" tax incentive in a country that grants incentives to new companies.

If a student wants to read a US case on this sort of multi-step circular arrangement, *Schering-Plough Corporation v U.S.A.*, 651 F.Supp.2d 219 (D.N.J. August 28, 2009), *affirmed* Merck & Co., Inc. v. U.S., 652 F.3d 475 (C.A.3 June 20, 2011), is an excellent example. In brief, Schering-Plough had successfully operated through several Swiss subsidiaries, accumulating many hundreds of millions of dollars of low-taxed foreign earnings that would be taxable in the US upon repatriation through dividends or upon any "investment in US property" (Code §956). As "investments in US property" generally include loans to the parent company, it was not possible for the Swiss subsidiaries to simply loan their cash balances to any US related party. In order to transfer funds into the US without creating a loan, Schering-Plough and one of its Swiss subsidiaries, along with Merrill Lynch and a Dutch bank, entered into a series of transactions. One important step in the series was the creation of a twenty-year long interest-rate swap between Schering-Plough and the Dutch bank under which the bank paid to Schering-Plough one defined stream of payments and Schering-Plough paid to the bank another defined stream of payments. Initially, these two streams were offset so that only a

small net amount was paid by one party to the other. As a second important step, Schering-Plough "sold" to its Swiss subsidiary the payments for years six through twenty that it would receive from the Dutch bank under the swap. So, for those future years, Schering-Plough would pay its defined payment to the bank and the bank would pay the economically offsetting payment to the Swiss subsidiary. The purchase price paid by the Swiss subsidiary for this future stream was a lump sum amount. Economically, the subsidiary would earn back this lump sum payment plus some additional amount through the future payments that it would receive directly from the Dutch bank. The court found that the Dutch bank was a mere intermediary and that the proper characterization of the transactions for US tax purposes was a direct loan from a subsidiary to a parent. As such, Code §956 applied to create immediate taxability to Schering-Plough of the amount loaned.

Tax authority reactions

Generally, where authorities know that a sham or fake transaction has occurred, they will disregard or re-characterize the transaction as appropriate to the situation. However, for the other types of situations shown in the above bullet points, there is considerable variation around the world. Each country has laws and practices that place it at some point along a spectrum between blindly accepting the legal form of the transactions and readily ignoring the legal form to tax the transaction(s) based on its/their substance and perhaps as well based on the tax authorities' perception of legislative purpose where that purpose is not expressly stated in the legislation. For example, some countries may treat the steps in a multi-step arrangement among related or unrelated parties as separate transactions independent of whether they make any business or commercial sense. Other countries may only respect each step in a multi-step arrangement where each can be supported commercially. Another issue is whether the terms and timing of the contracts/corporate actions are such that at the time of the first step it is preordained that all other steps will occur in due course. Or, was it realistically possible that later steps might not occur? Some countries that have been very form-oriented historically have approached multi-step transactions in this manner. If the real legal effect of a series of contracts/corporate actions is the net result because the terms of each step dictate that all must be completed, then that "net result" is the real legal form that should be the basis for taxation.

Over the past decade and more, there has been considerable movement by some number of countries from a more "form" oriented approach to examining "substance" before accepting the tax reporting of transactions. While this has primarily been a trend affecting purely domestic transactions, there has also been considerable development in the past few years of host and source countries in Asia and elsewhere around the world that have attempted to use GAAR provisions and "substance" concepts to attack what they perceive as treaty abuse.

A particularly good example of this is China, which previously had applied its tax laws on a very much "form" basis, but in its Enterprise Income Tax Law included a GAAR provision as part of its 2008 tax reform. In the past several years, as the Chinese authorities have gained a better understanding of the nature of tax avoidance and international structuring, they have aggressively attacked (i) treaty shopping through the "beneficial ownership" requirement applicable to dividends, interest and royalties and (ii) structures that attempt to avoid Chinese taxation when the shares of a non-Chinese holding company that owns a Chinese company are

sold as an indirect means of selling the Chinese shares. Starting in 2009, the State Administration of Taxation has issued a number of circulars that provide guidance on beneficial ownership as well as informational and document-reporting requirements on indirect transfers so that the tax authorities could adequately evaluate them for potential taxability. (For more detail on these developments, see the "GAAR and Sub v Form Matters" subdirectory in the "China—Mainland" page on the Course Website.)

In the high-profile Vodafone case, which was thought to have been concluded with an Indian Supreme Court decision on 20 January 2012, the Indian tax authorities unsuccessfully tried a similar stance to tax an indirect share transfer. As a part of its decision, the Supreme Court after carefully examining the facts of the case applied English and Indian decisions that give some precedent for a "judicial GAAR" and decided that the legal form should be respected and govern the tax consequences. (As the Supreme Court decision makes excellent reading, please see it and other items in the "Vodafone Case" subdirectory in the "India" page on the Course Website.) Expected future law changes in India include a statutory GAAR. Also following its loss in the Vodafone case, the Indian government enacted retroactive law changes that would effectively override this Indian Supreme Court decision. Following a new tax assessment against Vodafone, the case turned into an arbitration under the Dutch-India Bilateral Investment Treaty with a second dispute action being initiated by the Vodafone side under the U.K.-India Bilateral Investment Treaty. The arbitration process was still ongoing at the end of 2016.

Another high-profile case where local tax authorities have attempted to deny treaty benefits involves Korea and the US-based Lone Star private equity group. And the Australian tax authorities as well have been active in pursuing certain such transactions. See further discussion of this general area in the "Intermediate country" portion of Section O on "Tax effective locations".

Because tax authorities learn more over time and readily change their practices in this general area, the international tax planner cannot rely on recent experience but must always investigate current practice. A further caution in this regard is that a transaction executed today with knowledge of current tax authority practice will normally only be reviewed and judged by the tax authorities when an audit is conducted several years in the future. The tax authorities will apply at that time whatever their "current practice" has become. And that "current practice" at that time in the future may be very different from the current practice at the time of the transaction's planning and execution.

Although the above discussion covers possible practices of a country, it must be understood that within many countries there can be considerable divergence between the law as written, the practices of the tax authorities, and the willingness of the courts to sustain the law and the attacks of the tax authorities. By their nature, GAARs are often written in very general language in order to give the tax authorities great flexibility and discretion in fighting tax avoidance. Courts in some countries have been less than enthusiastic in applying these sometimes vague and ambiguous laws. Further, courts have not always been friendly to tax authorities attempting to apply these GAARs or internal tax authority practices that focus on "substance". The international planner must have a full understanding of the position of all the relevant players in

a country when planning is being considered that could be a target for anti-avoidance measures.

The book Comparative Income Taxation: A Structural Analysis, by Hugh J. Ault and Brian J. Arnold as principal authors (Aspen Publishers/Kluwer Law International, 2010), includes relatively brief summaries of the taxation systems for nine important countries, two of which are in Asia (Japan and Australia). The standard format for the summaries includes some good discussions for many of the countries on this "substance versus form" issue. Various OECD items also touch on this area. See, for example, extensive discussion in the context of transfer pricing in sections D.1. (Identifying the commercial and financial relations) and D.2. (Recognition of the accurately delineated transaction) of Chapter I of the Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations (Guidelines). As of late 2016, these sections have not yet been included in a revised edition of the Guidelines. Until a revised edition is issued, these sections may be found in the BEPS Actions 8-10 Final Report, "Aligning Transfer Pricing Outcomes with Value Creation, dated 5 October 2015, available at http://www.oecd.org/ctp/aligning-transfer-pricing-outcomes-with-value-creation-actions-8-10-2015-final-reports-9789264241244-en.htm.

Examples of typical form vs. substance issues

Some areas where form versus substance issues arise include:

- Characterization of the leasing of property as being a true lease or a sale,

- Characterization of an agreement as a lease or the performance of services (e.g., "Satellite transponder lease" agreement: Typically such agreements do not grant to the "lessee" possession of the transponder or any equipment. Rather, the lessee merely accesses its transmission capacity. As a result, such arrangements are normally characterized as services. See Para 9.1 of the OECD Commentary under Article 12 of the OECD Model Tax Convention.),

- Characterization of a loan from a parent company to its subsidiary as being true debt or a subscription of capital (note that many countries have what are termed "thin-capitalization" rules under which certain debt may be re-characterized as equity or, alternatively, the debt is not re-characterized but the interest thereon will be disallowed as a deduction; such statutory thin-capitalization rules are only applied after balance sheet liabilities are determined to be true debt for tax purposes under any form versus substance rules that the country has),

- Identification of the person who is truly earning certain income (e.g. one person conducts activities but the income contractually flows to a different person),

- Determination of whether a person is acting as a principal in his own right or an agent or mere nominee for some other person (e.g. person A loans money to person B who on-loans that money to person C (often termed a back-to-back loan); is B a principal so that

the two loans are respected as separate transactions or is B merely an agent or nominee so that there is only one loan direct from A to C?),

- Determination of whether one person is an independent contractor providing services for a second person, or whether that person is conducting the second person's business as an agent of that second person (e.g. where, in a typical supply chain structure, the low-taxed entrepreneur company has no personnel of its own capable of directing and managing its own business and therefore conducts its business operations (including for example, the manufacturing of products, R&D, marketing and sales activities) primarily through service agreements with related companies that regularly make business decisions and negotiate agreements with third parties, thereby conducting the business of the entrepreneur company),

- Determination of whether an individual's "employer" is the stated employer within an employment contract or whether a different company that is receiving the benefits of the individual's efforts should be considered the employer for tax purposes,

- Liquidation/re-incorporation transactions,

- Characterization of multiple related transactions (e.g. three construction contract situation described above; see paragraph 18 of the Commentary on Article 5 of the OECD Model Tax Convention.), and

- Characterization of royalty or other payments by an importer or reseller of imported property as being part of the base for customs duties (this may occur explicitly under the customs rules in some countries when such payments are related to imported goods).

As a final comment, since this is an area of significant divergence among countries in both law and practice, local counsel must be consulted whenever this issue could potentially arise.

R. Rulings

The tax authorities of some countries will provide rulings or opinions regarding the acceptable tax treatment of some actual or contemplated transactions. In some cases, there is underlying law or procedure in the country that makes such rulings or opinions binding on the courts in case of a future dispute. In many countries, though, such rulings or opinions (if provided at all) are merely the opinion of the particular tax official giving it and as such will not have binding effect in the courts or on the tax authority itself.

Even where not binding, a ruling or opinion provides some level of comfort regarding the tax treatment of the particular transaction. As a result, an important part of practicing international taxation is the decision of when to seek a ruling or opinion from the relevant authority.

It is fair to divide rulings into two categories. One category focuses on the characterization of one or more transactions and how the tax law applies to them. The tax authorities of just one

country normally issue such rulings. With the increasing interest of tax authorities around the world in communication amongst themselves and in possible joint audits and other joint activities, it is likely that rulings agreed to by more than one country may become commonplace in the not too distant future.

A second category, termed "advanced pricing agreement" (abbreviated as APA), involves an agreement between one or more related taxpayers and the tax authorities of one or more countries regarding price levels and/or pricing methodology. Such agreements can cover the pricing related to intra-group transactions involving tangible property such as manufactured merchandise, intra-group services, or intangible property such as a license of a patent. An APA between a taxpayer and one country's tax authority is termed a "unilateral APA". Where two or more countries' tax authorities are parties to the APA, it is termed respectively a "bilateral APA" or a "multilateral APA".

Note that the facts of the particular taxpayer requesting a ruling, opinion, or APA will be subject to examination. If the facts that have been provided to the tax authorities in the request are different in any way from facts as determined upon audit of the taxpayer, then the ruling, opinion, or APA may become ineffective. As a result, an accurate statement of the facts is of particular importance.

The granting of tax rulings received direct attention during the BEPS process. See the brief discussion of transparency regarding rulings in the BEPS section below and mention of the Lux-leaks documents in Section B above.

S. Transfer pricing

Introductory comments

As the subject of transfer pricing is covered elsewhere within the Tax LLM program, this subject is only briefly covered herein. The comments below focus principally on what is found outside the US. For those not already familiar with the US transfer pricing rules, it is worthwhile to read/scan the regulations found under Internal Revenue Code section 482. For comparison with other countries, there is a series of Bureau of National Affairs portfolios that focus specifically on the transfer pricing rules in selected countries. See portfolios 6940-1st through 6975-1st, Transfer Pricing: Rules and Practice in Selected Countries. These include several countries in the Asia/Pacific area (e.g. Japan, Korea, and Australia).

An increasing number of countries (reported to now exceed 100) have developed tax rules under which transactions between related parties or commonly controlled parties must be based on the "arm's length standard". In general, this means the price at which unrelated persons would agree to transact assuming neither is under any particular or unusual pressure to agree.

Transfer prices are the prices at which tangible goods (whether sales in the ordinary course of business or as one-time transactions such as fixed assets including real estate), services, financial transactions (including securities and loans)), and intangibles are transacted between

related parties. It also includes the rates at which money is loaned (interest), property is rented or leased (rental), and intangibles are licensed (royalty).

While most countries do have some sort of legislated concept of "related party" and the acceptable pricing methods that may be used, the definitions of terms and pricing methods do vary from country to country. For example, many countries will define related or commonly controlled parties by providing a percentage control test. The percentage test may define control as being over 50% common equity ownership. Sometimes, it will be 50% or more common ownership. Other control tests that will be found include common board of director members, common management, etc. Some countries have a lower percentage threshold for control. For example, in China, the ownership/control level is 25% or more.

There will, of course, also be different approaches to how different countries apply their respective transfer pricing rules and how much administrative resources they expend in examining and pursuing transfer pricing cases. For example, Japan has been known for both its use of "secret comparables" and its aggressiveness in pursuing transfer-pricing cases. The Japanese tax authorities have invested in training personnel who understand the economics and applicable transfer pricing rules. Many countries, on the other hand, have not made such investment and as a result are less able to raise and successfully prosecute transfer-pricing cases. Some countries apply transfer pricing rules only to cross-border transactions and do not apply them to pure domestic related party transactions. As one example, from 2008, Chinese law applies its transfer pricing rules to both international related party transactions and domestic related party transactions. However, rules issued under this law indicate that the principal focus will be on cross-border transactions.

Why is transfer pricing important?

Transfer pricing is important for both multi-national corporate groups and governments alike.

For governments, the transfer prices used directly affect the profits of taxpayers and, thus, tax revenues. Where product is imported, transfer pricing can also affect the level of any applicable customs duties, import VAT, and excise tax.

For corporate groups, transfer pricing has multiple effects that go far beyond merely their taxation concerns. Such effects can include the following:

- Transfer pricing affects the management accounts of each business unit within a corporate group. While the practices and policies of different groups of course vary, the level of each business unit's profit or loss by product line and in the aggregate will be a factor that management uses as a tool to evaluate its operations and its personnel and on which to base business decisions. The approach to transfer pricing may also affect the behavior of a business unit's management. For example, the management of a limited risk contract manufacturer or service company that is remunerated purely on a cost plus basis may not have much incentive to cut its operating costs. With the aid of sophisticated accounting systems, many companies minimize this crossover impact between statutory and management accounting by running essentially parallel

accounting systems, one of which is focused on management needs with the other focused on statutory tax accounting.

- Closely associated with parallel accounting systems is the issue of employee compensation. The terms of incentive compensation plans may be structured to incentivize certain employees to think beyond the one group member that employs them. As such, the bonus pool for a particular officer or employee might include the combined results for several group members. Where there are intercompany transactions between these several group members, the employee will not be influenced to maximize the operating results of any one group member through transfer pricing mechanisms. Rather, he will work toward the highest combined profitability for the several group members. If the base for his incentive compensation is after taxation, then this, of course, could also incentivize him to set intercompany transfer prices that are within his control to levels that minimize taxation and maximize the combined after-tax profits. This can, on occasion, cause intercompany pricing decisions that are perhaps inconsistent with good arm's length transfer pricing principles. As a result, a better management approach is to always base incentive compensation on pre-tax profits. (Note the comment on "conflict of interest" in the BEPS section as being a systemic factor strongly motivating BEPS behavior.)

  While on the subject of compensation, there's another issue that should be mentioned. The existence of significant differences between the relative profits used for compensation and those used for tax reporting purposes can be a strong indication that those used for tax reporting are subject to considerable risk of adjustment. This is becoming increasingly true with the greater focus of the BEPS project on aligning taxation with value creation. Thus, for example, say that an MNE has placed entrepreneurial benefits and risk for its supply chain within a low-taxed group member X in country A. However, the personnel managing and controlling X's entrepreneurial benefits and risks work within a higher-taxed group member Y in country B. These personnel perform these functions under a service agreement between X and Y that compensates Y using a cost-plus 5% service fee. Despite the fact that Y receives only a limited level of profit, the Y personnel's incentive compensation is based on the combined profits of X and Y. In such a situation, the country B tax authorities would likely have a strong basis to question the cost-plus 5% transfer pricing mechanism that compensates Y for the services performed.

- Transfer pricing affects the taxable income or loss within each business unit and, on a group-wide basis, the effective tax rate on the group's worldwide financial statements, which will affect share prices and market capitalization of the group.

- Transfer pricing affects the amount of customs duty, import VAT, and excise tax.

- Transfer pricing represents one of the biggest areas of tax risk facing most groups as well as most governments. This is primarily because even a small change in a group's transfer pricing may have very significant effects on the pre-tax net income and taxation of each group member with the amount of tax at issue often being in the multi-millions of

dollars and even sometimes in the billions. For that reason, some number of taxpayers and governments have been working together to negotiate and execute advance pricing agreements. In addition, transfer-pricing audits can be very costly to taxpayers and governments alike. On the taxpayer side, in addition to the resources of in-house tax personnel, they can require significant involvement by non-tax employees and executives within the company as well as outside expert advisors. On the government side, especially in the case of developing countries, there will be limited numbers of qualified examiners as well as a need for outside industry and valuation specialists. Even with developed countries, there can be significant resource issues. For example, it was reported that the US IRS, in connection with its ongoing transfer pricing audit of certain Microsoft group intercompany transactions, hired an outside law firm for assistance at a cost in excess of US$2 million.

OECD Guidelines, the UN, and the arm's length standard

Recognizing the importance of transfer pricing to international business and investment, the OECD issued guidelines for transfer pricing originally in 1979 and then updated these guidelines in 1995 and then again in 2009 and 2010. A copy of these guidelines in booklet form is available in soft copy on the OECD iLibrary website. See Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations, Organisation of Economic Co-Operation and Development, 2010 (hereinafter referred to as "Guidelines"). With the issuance on 5 October 2015 of the various BEPS project Final Reports, one of which provide for significant Guideline amendments, and on 4 July 2016 a draft of planned amendments to the business restructurings chapter, it may be expected that an updated Guidelines will be issued before too long.

The Guidelines make clear that the OECD believes that the basis of transfer pricing should be "arm's length" pricing. This is in contrast to other possible methods such as apportioning income among related entities on some global formula approach or the full-inclusion taxation system. (See further discussion on these two approaches later in this paper in the section on the BEPS project.) Consistent with this commitment to the "arm's length standard", Masatsugu Asakawa, who is the chair of the OECD Committee on Fiscal Affairs, stated the following in an article ("Transfer Pricing in the New Global Landscape: The OECD's Engagement Beyond Its Borders", Tax Notes International, 64 Tax Notes Int'l 209 (17 October 2011)):

> We are very aware of the challenges faced by many countries in implementing transfer pricing rules. Indeed, many of these challenges have been faced by OECD member countries. We are also very aware that, partly as a result of these challenges, some have advocated an alternative approach to transfer pricing, such as global formulary apportionment. We are far from convinced that such an approach represents a realistic option in the current international tax landscape -- it is difficult to see, for example, how the required consensus on the computations of the profit base to be apportioned between countries, or allocation formulae to be applied to split that profit between countries, would be achieved, and it is far from demonstrated that any such approach would be advantageous to developing countries.
>
> Clearly, the arm's-length principle should be neither rigid nor immovable, but we believe it is the only realistic option in the interests of developing countries….

This opinion from 2011 still represents the OECD approach today, as evidenced by the BEPS project scope and output. See further discussion on this limitation on the BEPS project's scope later in this paper in the section on the BEPS project.

The OECD has been reasonably characterized as being a rich countries' club. What about the rest of the world? Do they agree that this approach of looking solely to the "arm's-length standard" is "the only realistic option"? The UN Committee of Experts on International Cooperation in Tax Matters, as a subsidiary body of the UN Economic and Social Council, gives special attention to developing countries and countries with economies in transition. This Committee of Experts, which is responsible for the UN Model Tax Convention, approved on 15 October 2012 its "Practical Manual on Transfer Pricing for Developing Countries" (see http://www.un.org/esa/ffd/documents/UN_Manual_TransferPricing.pdf). This "Practical Manual" endorses the arm's length standard. In regard to this, the Preface to the Manual includes:

> While it is for each country to choose its tax system, this Manual is addressed at countries seeking to apply the "arm's length standard" to transfer pricing issues. This is the approach which nearly every country seeking to address such issues has decided to take. Such an approach minimizes double taxation disputes with other countries, with their potential impact on how a country's investment "climate" is viewed, while combating potential profit shifting between jurisdictions where an MNE operates.
>
> In recognizing the practical reality of the widespread support for, and reliance on, the arm's length standard among both developing and developed countries, the drafters of the Manual have not found it necessary, or helpful, for it to take a position on wider debates about other possible standards. The Manual will, at most, help inform such debates at the practical level, and encourage developing country inputs into debates of great importance to all countries and taxpayers.

Although this conclusion regarding the arm's length standard has now been made, a few developing counties and some commentators had previously questioned sole reliance on the arm's length standard, with India being particularly vocal about the tax bases of developing countries being eroded. Increasingly, some commentators are raising in particular the need for the world to adopt a unitary approach. See Durst, 6938 T.M., A Formulary System for Dividing Income Among Taxing Jurisdictions. Regarding the full-inclusion approach, see Kadet, "Worldwide Tax Reform: Reversing the Race to the Bottom", 138 Tax Notes 1245 (March 11, 2013), available at http://ssrn.com/abstract=2231915.

To some extent, the OECD in recent years has been giving more than mere lip service to the interests of developing countries. One pre-BEPS project example is the change made to the OECD Commentary under Article 5 concerning service permanent establishments. Another is the discussion draft on transfer pricing safe-harbors that was reissued in late 2012. And as mentioned in the below section on the BEPS project, certain developing countries were included in the BEPS project two-year deliberations and many more will be participating in future BEPS work and BEPS implementation.

While the arm's length standard may have been agreed upon, there can be considerable differences in its application between developed and developing countries. As an excellent example of this, both India and China submitted comments in 2012 as sections of Chapter 10 of the UN Practical Transfer Pricing Manual that provide their respective developing country perspectives on the application of the arms' length standard. For example, both countries raise their strong views regarding the treatment of "location savings", which can refer to factors such as low cost labor, proximity to vendors and markets, etc. See Chapter 10.3 and 10.4 of the UN Practical Transfer Pricing Manual at the above-provided link. Presumably due to pressure from these countries, the "Actions 8-10 Final Reports, Aligning Transfer Pricing Outcomes with Value Creation", 5 October 2015 (Actions 8-10 Final Reports), includes new section D.6. of Chapter I of the Guidelines covering "Location savings and other local market features".

Needless to say, future developments in this area will be very interesting. And, to the extent that countries apply either standards different from the arm's length standard or apply location savings and other issues differently, then international tax planning will be significantly affected and the potential for double-taxation (and double-non-taxation as well) increased exponentially.

There is one final important point to make in this section on the guidance provide by the OECD issued Guidelines and the UN Practical Manual. These documents provide guidance; they are not law. Each country enacts its own tax laws for transfer pricing and develops its own transfer pricing interpretations and practices. In some cases, such laws and interpretations may refer to the Guidelines or give them some level of formal or informal respect and weight. Courts may refer to them as well. The point is that the Guidelines and the UN Practical Manual can provide important and useful help in analyzing MNEs and their operations. However, it is absolutely necessary to discuss with local counsel the details of any specific situation.

Transfer pricing methods

The Guidelines, which designate a number of different methods by which it is possible to determine arm's length prices, recognize that no one method is applicable to all transactions. Rather, the character of each situation and the surrounding circumstances will allow judgment to be applied so as to determine the most appropriate method or methods. Prior to the 2010 update of the Guidelines, the three "traditional transaction methods" described below were given preference over the "transactional profit methods", also described below. The latter were to be used only as a last resort on an exceptional basis when one of the former methods could not be reliably applied. With the 2010 update, however, this preferential treatment given to the "traditional transaction methods" has been abandoned. Now, the transfer pricing method selected by a taxpayer or imposed by country's tax authorities should be the "most appropriate method to the circumstances of the case". The stated reason for this proposed change is "…experience acquired in applying transactional profit methods since 1995…."

Following are very brief descriptions of the five transfer pricing methods as defined in the Guidelines. You as students are very much encouraged to read, or at least scan, the full description and discussion of these methods and related material in both the current Guidelines and in the amendments to the current Guidelines included in the Actions 8-10 Final Reports. Important matters include the guidance on identifying commercial or financial relations so as to accurately delineate transactions, functional analysis including the analysis of risks, understanding the characteristics of products and services, transfer pricing methods and

selection of the most appropriate method, comparability, comparability adjustments, the arm's length range, and location savings. See in particular Chapters II and III in the current Guidelines and newly redrafted Section D of Chapter I on pages 13*ff* in the Actions 8-10 Final Reports. This new Section D covers basic concepts including the delineation of the actual controlled transaction, functional analysis, risk, and other important topics.

Traditional transaction methods

- The comparable uncontrolled price (CUP) method (see pages 63*ff* in the Guidelines)

  "The CUP method compares the price charged for property or services transferred in a controlled transaction to the price charged for property or services transferred in a comparable uncontrolled transaction in comparable circumstances." The Guidelines go on to say: "…an uncontrolled transaction is comparable to a controlled transaction (i.e. it is a comparable uncontrolled transaction) for purposes of the CUP method if one of two conditions is met: a) none of the differences (if any) between the transactions being compared or between the enterprises undertaking those transactions could materially affect the price in the open market; or b) reasonably accurate adjustments can be made to eliminate the material effects of such differences. Where it is possible to locate comparable uncontrolled transactions, the CUP Method is the most direct and reliable way to apply the arm's length principle. Consequently, in such cases the CUP Method is preferable over all other methods."

  The Guidelines acknowledge that it may be difficult to find sufficiently comparable uncontrolled transactions so that it may be impossible to use the CUP method.

- The resale price method (see pages 65*ff* in the Guidelines)

  This method, which is generally most applicable to related party sales to distributors and marketing companies, calculates transfer prices by working backward from the sales price at which that distributor or marketing company sells to an unrelated third party. From that sales price, an appropriate gross margin (termed the "resale price margin" in the Guidelines) is subtracted to arrive at the arm's length price between the two related parties. That gross margin represents the distributor or marketing company's expenses and profits.

  The Guidelines provide: "The resale price margin of the reseller in the controlled transaction may be determined by reference to the resale price margin that the same reseller earns on items purchased and sold in comparable uncontrolled transactions ('internal comparable'). Also, the resale price margin earned by an independent enterprise in comparable uncontrolled transactions may serve as a guide ('external comparable')." The Guidelines further state: "…an uncontrolled transaction is comparable to a controlled transaction (i.e. it is a comparable uncontrolled transaction) for purposes of the resale price method if one of two conditions is met: a) none of the differences (if any) between the transactions being compared or between the enterprises undertaking those transactions could materially affect the resale price margin in the open market; or b) reasonably accurate adjustments can be made to eliminate the material effects of such differences. In making comparisons for purposes of the resale price method, fewer adjustments are normally needed to account for product differences than

under the CUP Method, because minor product differences are less likely to have as material an effect on profit margins as they do on price."

In making these controlled/uncontrolled comparisons, note that the comparison is not on the specific product that has been sold. Rather, it is on the functions performed by the related party reseller. For this purpose, the reseller's functions are examined, taking into account assets used and risks assumed.

- The cost plus method (see pages 70*ff* in the Guidelines)

  This method, which is generally most applicable to related-party transactions such as sales of semi-finished goods, long-term buy-and-supply arrangements, and the provision of services, calculates transfer prices by working forward from the costs of the related party seller/service provider and then adding to those costs a appropriate mark-up. The mark-up includes both an allowance for indirect costs of the party plus its profit.

  The Guidelines include similar comments for the mark-up to those quoted above for the resale price margin. And similarly, the comparisons to determine the mark-up percentage require an analysis of the related party's functions, taking into account assets used and risks assumed.

Transactional profit methods

- The profit split method (see pages 93*ff* in the Guidelines)

  This method generally calculates the group-wide operating profits from the relevant transaction(s) and then allocates those operating profits among the relevant group members. This allocation should be made "on an economically valid basis that approximates the division of profits that would have been anticipated and reflected in an agreement made at arm's length." The basis used should "[b]e consistent with the functional analysis of the controlled transaction under review, and in particular reflect the allocation of risks among the parties". Profits are usually calculated before taxes and interest and in some cases gross profit is used instead of operating profit.

  Because of the difficulties in establishing arm's length prices with today's integrated MNE supply chains and other structures, one of the outcomes from the BEPS project is an expectation that this profit split method will be used more often in the future. Additional BEPS project work conducted during 2016 within the OECD resulted in a discussion draft dated 4 July 2016 with revised guidance on profit splits. Likely, this work will be completed in 2017 with changes being reflected in the next edition of the Guidelines.

- The transactional net margin method (see pages 77*ff* in the Guidelines)

  This method is conceptually similar to the resale and cost plus methods mentioned above except that the net profit margin is the focus rather than the resale price margin or

the mark-up, respectively, of those two methods. The comments made for those two methods generally apply to this transactional net margin method as well.

In contrast to the profit split method where the functional analysis is applied to both parties to determine a basis on which to split the group-wide profits, the analysis in this transactional net margin method is normally just applied to the related party that is performing less complex functions and that is not making any unique contributions. For example, say that a US company owns valuable industrial IP and has entered into a contract manufacturing agreement with its Chinese manufacturing subsidiary, which only applies non-unique manufacturing processes in fulfilling its obligations under the arrangement. In applying the transactional net margin method, the analysis would only focus on the Chinese subsidiary as the "tested party" and would ignore the US company. As such, a comparable profit margin factor could be determined for this "tested party" and that would be used to set the level of profit allocated to this "tested party". The remainder would be allocated to the US company. Or, if the US company with the valuable industrial IP were selling through a related distributor that was performing non-unique selling functions, then the latter would be the "tested party" and a comparable profit margin factor developed for it.

The above discussion focuses primarily on the transfer pricing of products. Transfer pricing concerns, though, arise with all transactions between related parties. These include, for example, the performance of services, the leasing of real and personal property, the sale of non-inventory property, and the sale or licensing of intangibles. Various countries have more or less sophisticated rules that deal with these other types of transactions.

Special areas

Services

It often occurs within a group of related companies that services are performed in country A by company X for its related company Y in country B. And Y pays X for the services rendered. These services by X might be specific services related to some product that Y manufactures and sells. For example, say that X performs an engineering study or performs certain structural tests on samples of the products that Y produces to confirm the quality of the Y manufactured products. Or, the services performed by X might be administrative and management services that could include human resource support, production management support, sales support, legal support, accounting and financial support, tax support, etc. In all these cases, X is performing real services for Y. And Y is paying an arms' length charge for those services.

Within country B, the payment by Y of these services charges will normally be deductible expenses. (If they help Y create a capital asset, then perhaps the amounts must be capitalized into the cost of the capitalized asset rather than being allowed as immediate deductions.) As with any related party transaction, the country B tax authorities will be very interested in assuring that real services were performed and that the charge is arms' length under country B's transfer pricing rules. Often, to establish this to the B tax authorities, Y must maintain not only

the contract and related documentation under which the service charge was paid (e.g. invoice, etc.), but also very good documentation on what the service was, how it in fact benefited Y's business, and the basis for the charge. In this regard, if the charge is not for specific services performed but is for general management support rendered by X's executives and various support functions (e.g. finance, legal, etc.), the country B tax authorities might not allow any deduction, especially where the charge is calculated by an allocation formula that X uses to charge these X executive costs to many or all of its subsidiaries around the world.

Because intercompany charges for management fees, head office expenses, and the like have often been seen by many countries, especially developing countries, as being tax base eroding payments, the BEPS project focused close attention on this area. As a part of the updating of Chapter VII of the Guidelines on "Special Considerations for Intra-Group Services", an elective, simplified approach for "low value-adding services" was introduced. This approach provides a wide category of common intra-group services, application of consistently applied allocation keys, and greater transparency including documentation for the costs pool. Interestingly, this simplified approach also provides for a "moderate mark-up of 5%", which has been less than enthusiastically received by some commentators from developing countries. Further work is planned so that this approach can be implemented by a broad number of countries before 2018. See pages 141*ff* of the Actions 8-10 Final Reports.

The prior paragraphs focus on deductibility to Y and country B's transfer pricing rules. For the sake of more complete discussion, what about country B's taxation of X? While some countries do apply a withholding tax to payments for "technical services", often the domestic law of country B and its tax treaties do not tax service charges generally where the services were performed outside of country B. The usual approach, especially under tax treaties, is that the service fees are treated as business profits. And as long as X does not have a permanent establishment in country Y, Y does not tax the service fees either directly or through a withholding tax. This is what Article 7 of the OECD Model Tax Convention provides. Note that Article 7 is very broad in this regard. Even if some of the services are performed by X personnel who travel to the Y offices in country B so that some of the service income is sourced in country B, there will be no country B tax as long as X has no permanent establishment in country B. Some treaties have a "service PE" provision in Article 5 so that if X personnel spend too much time in country B, there will be a permanent establishment of X in country B. See (i) the UN Model Tax Convention Paragraph 3(b) of Article 5 and Paragraphs 9 through 12 of the Article 5 UN Commentary, and (ii) Paragraphs 42.11 through 42.48 of the Commentary under Article 5 of the OECD Model Tax Convention.

An important point, of course, is that any such service fees must be for real services that benefit the business of Y. We have to distinguish between two possible types of activities that X might perform. Assume that X is the 100% parent. X can perform services that benefit the business of Y. For example, Y plans to enter into a sales contract with a new customer and seeks help from the in-house legal section in X about the draft of the sales contract. The legal support provided by X directly helps the business of Y. On the other hand, say that personnel in the X finance department spend time analyzing the financial results of Y. They look at Y's balance sheet, income statement, and various sales, production, and personnel reports, all of which were prepared by Y's accounting group working in country B. Y's management has not asked X

for any help in analyzing these internally produced documents. X is doing this analysis because of its interest as an investor in Y. Under general transfer pricing concepts, such expenses of X related to its status as an investor are sometimes called "shareholder activity" costs and may not be charged to Y. Only expenses for X's activities that truly benefit the business of Y can be charged to Y. See Paragraphs 7.9 and 7.10 of amended Guidelines Chapter VII on pages 144-145 of the Actions 8-10 Final Reports.

Intangibles

Intangibles are of particular importance to transfer pricing. Within any multinational group of companies that holds significant intangible property important to the group's profitability, those intangibles may significantly affect intra-group product sales prices, service charges, and royalties, thereby affecting the relative amount of income or loss realized by each group member. As indicated in the below sections on cost contribution arrangements and business restructurings, there can also be transfers of ownership of intangible property that require valuations. In this area, there is significant potential for disputes between tax authorities and taxpayers.

As the 2010 update of the Guidelines did not significantly deal with either Chapter VI on intangible property or Chapter VIII on cost contribution arrangements, both of which dated back to the mid-1990s, an updating of these chapters was initiated shortly after the mid-2010 issuance of the 2010 Guidelines. Following controversial discussion drafts issued in 2012 and then revised in 2013, the project to update these chapters was folded into the BEPS project. It will be appreciated that since many BEPS structures have depended on transferring rights to intangibles into MNE group members located in zero or low-tax countries, a principal focus of the BEPS project included approaches to dealing with difficult-to-value intangibles. After additional discussion drafts issued during the 2013 – 2015 BEPS project, many hundreds of pages of comments, and hearings, the Actions 8-10 Final Reports were issued on 5 October 2015.

The Actions 8-10 Final Reports provide a new Chapter VI of the Guidelines, expected to be labeled "Special Considerations for Intangibles". In brief, this new chapter sets out principles through which the arm's length standard should be rigorously applied to intangibles. As additional guidance, the Actions 8-10 Final Reports include twenty-nine examples that will be very useful in understanding the application of these principles. Students particularly interested in this aspect of transfer pricing are strongly encouraged to study this new Chapter VI in detail.

The following few points have been taken from the Actions 8-10 Final Reports:

- How is "Intangible" defined?

  "Intangible" is very broadly defined in a very practical fashion that eschews reliance on labels or categories. It "is intended to address something which is not a physical asset or a financial asset, which is capable of being owned or controlled for use in commercial activities, and whose use or transfer would be compensated had it occurred in a transaction between independent parties in comparable circumstances. Rather than

focusing on accounting or legal definitions, the thrust of a transfer pricing analysis in a matter involving intangibles should be the determination of the conditions that would be agreed upon between independent parties for a comparable transaction." [Paragraph 6.6 on page 67 of the Actions 8-10 Final Reports; footnote omitted.]

"The availability and extent of legal, contractual, or other forms of protection may affect the value of an item and the returns that should be attributed to it. The existence of such protection is not, however, a necessary condition for an item to be characterised as an intangible for transfer pricing purposes. Similarly, while some intangibles may be identified separately and transferred on a segregated basis, other intangibles may be transferred only in combination with other business assets. Therefore, separate transferability is not a necessary condition for an item to be characterised as an intangible for transfer pricing purposes." [Paragraph 6.8 on page 67 of the Actions 8-10 Final Reports.]

- Which member or members of a group are ultimately entitled to share in the returns derived by the group from exploiting intangibles?

  Under the Actions 8-10 Final Reports, neither mere legal ownership nor the mere bearing of costs related to intangible development is sufficient to provide a group member such returns.

  First, as general guidance, Paragraph 6.32 on pages 73-74 provides: "Although the legal owner of an intangible may receive the proceeds from exploitation of the intangible, other members of the legal owner's MNE group may have performed functions, used assets, or assumed risks that are expected to contribute to the value of the intangible. Members of the MNE group performing such functions, using such assets, and assuming such risks must be compensated for their contributions under the arm's length principle." [Footnote omitted.]

  Paragraph 6.34 then sets out a framework for analyzing transactions involving intangibles, including several steps relevant to this issue of which members are entitled to share in returns. These steps include (i) identifying the full contractual arrangements, (ii) identifying the parties performing functions, using assets, and managing risks, including which parties control any outsourced functions and economically significant risks, and (iii) confirming whether there is consistency between the terms of the relevant contractual arrangements and the conduct of the parties, importantly including whether the party assuming economically significant risks actually controls the risks and has the financial capacity to assume those risks.

  Paragraph 6.42 gets to the heart of the matter: "While determining legal ownership and contractual arrangements is an important first step in the analysis, these determinations are separate and distinct from the question of remuneration under the arm's length principle. For transfer pricing purposes, legal ownership of intangibles, by itself, does not confer any right ultimately to retain returns derived by the MNE group from exploiting the intangible, even though such returns may initially accrue to the legal owner as a result of

its legal or contractual right to exploit the intangible. The return ultimately retained by or attributed to the legal owner depends upon the functions it performs, the assets it uses, and the risks it assumes, and upon the contributions made by other MNE group members through their functions performed, assets used, and risks assumed. For example, in the case of an internally developed intangible, if the legal owner performs no relevant functions, uses no relevant assets, and assumes no relevant risks, but acts solely as a title holding entity, the legal owner will not ultimately be entitled to any portion of the return derived by the MNE group from the exploitation of the intangible other than arm's length compensation, if any, for holding title."

Paragraphs 6.50-6.58 include discussion of outsourcing functions to other group members. While it is clearly acceptable for a legal owner of intangibles to outsource various functions to other group members that act as independent contractors, the retention by the legal owner of any entitlement to share in returns will depend on whether the activities of the independent contractor group members are actually controlled by the legal owner. If the independent contractor group members are in fact controlled by a group member other than the legal owner, then that controlling group member will be entitled to appropriately share in returns. Control for this purpose generally includes the capability to make decisions along with the actual performance of the decision-making functions. See Section D.1.2.1. of Chapter 1 beginning on page 21 of the Actions 8-10 Final Reports for discussion of control.

Paragraphs 6.59-6.64 focus on the use of assets in the development, enhancement, maintenance, protection, and exploitation of an intangible. An important issue is what entitlement is there to share in return from funding. Guidance provided includes: "One member of an MNE group may fund some or all of the development, enhancement, maintenance, and protection of an intangible, while one or more other members perform all of the relevant functions. When assessing the appropriate anticipated return to funding in such circumstances, it should be recognised that in arm's length transactions, a party that provides funding, but does not control the risks or perform other functions associated with the funded activity or asset, generally does not receive anticipated returns equivalent to those received by an otherwise similarly-situated investor who also performs and controls important functions and controls important risks associated with the funded activity."

Further guidance: "When identifying risks in relation to an investment with specificity, it is important to distinguish between the financial risks that are linked to the funding provided for the investments and the operational risks that are linked to the operational activities for which the funding is used, such as for example the development risk when the funding is used for developing a new intangible. Where a party providing funding exercises control over the financial risk associated with the provision of funding, without the assumption of, including the control over, any other specific risk, it could generally only expect a risk-adjusted return on its funding."

Consistent with the above discussion on control when the legal owner of an intangible outsources certain functions, the guidance in regard to funding notes that control over a

specific financial risk requires the capability to make the relevant decisions related to the risk bearing opportunity, in this case the provision of the funding, together with the actual performance of these decision making functions. Where the funding group member has no capability to control the financial risk (e.g. it has no employees having relevant experience, knowledge, or authority), then that member is entitled to no more than a risk-free return for its funding activities. (See Examples 16 and 17 on pages 129-131 of the Actions 8-10 Final Reports regarding funding.)

To emphasize the importance that a group member must be able to itself control the risks with respect to intangibles it acquires from another group member and the R&D that it contractually arranges for another group member to perform to further develop those intangibles, Example 16 describes a situation wherein a parent company has transferred intangibles at an arm's length price to a newly formed manufacturing subsidiary in another country. Subsequent to the intangible transfer, the new manufacturing subsidiary enters into cost-plus R&D contract research agreements with its parent and another related company so that the new subsidiary will assume all risks and costs of future R&D. The new subsidiary, however, has no technical personnel capable of conducting or supervising the research activities so that these functions continue to be performed by the parent company. In these circumstances, this Example 16 concludes that the transaction is properly delineated as the provision of financing by the new subsidiary of the total costs of the acquired intangibles and the ongoing development. As such, the new subsidiary is entitled only to remuneration for its manufacturing functions and a risk-free return for its funding activities. This result is clearly contrary to the basis upon which many US and other country-based MNEs have set up their international tax planning to shift risks and profits into nil or low-taxed group members.

- What risks are relevant in determining which group member or members are entitled to share in intangible returns"?

  "Particular types of risk that may have importance in a functional analysis relating to transactions involving intangibles include (i) risks related to development of intangibles including the risk that costly research and development or marketing activities will prove to be unsuccessful, and taking into account the timing of the investment (for example, whether the investment is made at an early stage, mid-way through the development process, or at a late stage will impact the level of the underlying investment risk); (ii) the risk of product obsolescence, including the possibility that technological advances of competitors will adversely affect the value of the intangibles; (iii) infringement risk, including the risk that defence of intangible rights or defence against other persons' claims of infringement may prove to be time consuming and/or costly; (iv) product liability and similar risks related to products and services based on the intangibles; and (v) exploitation risks, uncertainties in relation to the returns to be generated by the intangible." [Paragraph 6.65 on page 82 of the Actions 8-10 Final Reports.]

- What about hard to value intangibles?

  Paragraph 6.189 on page 110 of the Actions 8-10 Final Reports provide: "The term hard-to-value intangibles (HTVI) covers intangibles or rights in intangibles for which, at the time of their transfer between associated enterprises, (i) no reliable comparables exist, and (ii) at the time the transactions was entered into, the projections of future cash flows or income expected to be derived from the transferred intangible, or the assumptions used in valuing the intangible are highly uncertain, making it difficult to predict the level of ultimate success of the intangible at the time of the transfer."

  In light of the existence of such HTVIs, the Actions 8-10 Final Reports note the "information asymmetry" between MNEs and tax authorities. While MNEs understand their businesses and have detailed knowledge of all existing intangibles and business processes, the various tax authorities whose job it is to review their intercompany pricing have limited knowledge of the MNEs, their internal operations, and their industry sectors. This of course places tax authorities at an extreme disadvantage in any analysis of HTVI transactions.

  Considering this situation, the Actions 8-10 Final Reports at pages 109*ff* include in Section D.4. of Chapter VI a procedure under which *ex post* results are compared with the *ex ante* projections. Where there are significant differences, then "the tax administration can consider *ex post* outcomes as presumptive evidence about the appropriateness of the *ex ante* pricing arrangements."

  Where there are such significant differences, new Section D.4. provides certain exceptions. One such exception is the existence of a bilateral or multilateral advance pricing agreement covering the transaction. Another applies if two conditions are met. The first is that the MNE provides details of its *ex ante* projections originally used to set the pricing arrangements. The second is the existence of reliable evidence that the significant differences are due to (i) post-transaction developments or events that could not have been anticipated at the time of the transaction, or (ii) foreseeable outcomes that were not significantly overestimated or underestimated in the pricing arrangements.

  As an example of a post-transaction development or event, Paragraph 6.194 comments: "[I]f the evidence of financial outcomes shows that sales of products exploiting the transferred intangible reached 1000 a year, but the *ex ante* pricing arrangements were based on projections that considered sales reaching a maximum of only 100 a year, then the tax administration should consider the reasons for sales reaching such higher volumes. If the higher volumes were due to, for example, an exponentially higher demand for the products incorporating the intangible caused by a natural disaster or some other unexpected event that was clearly unforeseeable at the time of the transaction or appropriately given a very low probability of occurrence, then the *ex ante* pricing should be recognised as being at arm's length…."

  There are plans to issue further guidance on this new approach for HTVIs with a review to be conducted in 2020.

One additional point should be noted. In the below section on cost contribution arrangements, it is noted that the development CCA mechanism has been a key component within many successful MNE profit-shifting structures. It is also noted that MNE parent companies will sometimes transfer intangibles to foreign subsidiaries through sales or exchanges either separate from or in connection with the execution of a CCA. While the CCA itself is subject to the Chapter VIII principles and rules, the intangible transfers will be covered by these Chapter VI principles and rules. Where MNEs rely on license agreements to make necessary intangibles available to their foreign subsidiaries, the level of royalties under such license agreements are covered by these Chapter VI principles and rules.

Cost contribution arrangements

A particular area of interest internationally is the cost contribution arrangement (CCA). In brief, a CCA is an agreement among several parties to share the costs of some common activity or project. While most focus of this subject is on its use to jointly develop intangible property (a development CCA), it is also a mechanism that can be used for services and certain other activities such as the creation of a tangible asset. Chapter VIII of the Guidelines, which provides significant discussion of CCAs, has been fully rewritten in the Actions 8-10 Final Reports; see pages 161*ff*. Any student having a particular interest in this area should read, or at least scan, this Chapter VIII. (Note also that the US Section 482 transfer pricing rules refer to such agreements as cost sharing agreements, often abbreviated as "CSAs". The US rules may be found in Regulation section 1.482-7.)

It is common, for example, within a corporate group for there to be one or more central and/or regional management and service locations that provide services to other group members. Such services could include product support, accounting and legal support, human resource administration, payroll services, etc. Under a service CCA, the costs of these services are spread amongst the group members that benefit from the services on some agreed basis that reflects the relative benefits to be derived by each participant. (Technically, the value of the services is the measure, but typically cost would be used as a practical means to measure the value of each participant's contribution of services in a service CCA.) Note that due to the use of a CCA, several things happen. First, there is a mutual sharing of costs rather than one entity providing services for another. As a result, under normal circumstances, no one entity earns any revenue or profit element from the arrangement; the participating group members book only expenses and, as necessary, make balancing payments amongst themselves so that each member books the correct amount of expense. Second, this characterization as expenses with no member earning any revenue means that there can be no withholding or other taxes that might otherwise be imposed if a participant were paying service fees to a service provider. Some countries impose withholding taxes on certain service fees or may attempt to limit their deductibility when paid to related parties. As such, this characterization can sometimes produce very beneficial tax results. (See section above concerning "Services", which includes discussion of intercompany charges. In contrast to this service CCA where no group member records revenues, in the case of actual service fees, there is invoicing of charges among group members such that one or more group members record service revenues and others record the applicable expenditures.)

In the case of a development CCA, the participating group members will all contribute to some defined research project. The amount of each participant's contributions and balancing payments will typically depend on the relative expected benefits that each hopes to achieve. And each participant will directly own a defined portion of the intangibles developed, if any. The defined portion received is then exploited by each participant in the conduct of its own individual business.

As an example, say that a US parent company owns the rights to exploit certain intangibles within the US while one of its foreign subsidiaries owns the rights to exploit those intangibles outside the US. A research team within the US parent will conduct a project to expand and further develop the intangibles. The US parent and its subsidiary enter into a development CCA under which each contributes to the costs of the project in proportion to the expected benefits to be derived. The US parent contributes its facilities and the work of the research team while the subsidiary makes a balancing payment of cash. To the extent that any new intangibles are developed (say they allow the manufacture and sale of a new product), the US parent owns the rights to exploit those intangibles in the US and the subsidiary owns the rights to exploit them elsewhere in the world. Exploitation occurs as each of the parent and the subsidiary begins to manufacture the product and sells it into its respective territory.

In the absence of a development CCA, the US parent at its own expense would develop the intangibles and then license them to the subsidiary, thus requiring a royalty stream to be paid by the subsidiary to the US parent. Such a royalty stream means two things. First, the country of the subsidiary (and potentially other source countries) may impose withholding tax. Second, the parent in the US will recognize royalty income, which after expenses will be subjected to a 35% corporate income tax (reduced of course by available foreign tax credits). In contrast, with a development CCA, there is legally no royalty being paid. Rather, the subsidiary is paying its share of the costs to conduct R&D through the balancing payments it makes, which costs most countries will allow as a currently deductible expense without any royalty withholding tax obligation. And as many countries encourage R&D through tax incentives such as super-deductions or tax credits, the subsidiary might also qualify for such benefits because of this characterization that its balancing payments represent directly incurred R&D expenses.

A particularly important point to understand is that where a royalty is being paid, there is economically a "profit element" within the royalty that shifts some amount of profit from the subsidiary to the US parent. This is because the US parent owns the worldwide rights to the intangibles and must realize the appropriate economic returns from that ownership. Under a development CCA, by paying its share of the development costs and taking the risk that nothing of value would be created, the subsidiary truly owns the non-US rights to the intangibles and should earn 100% of any resulting profits from the exploitation of those intangibles outside the US. This development CCA mechanism has been a key component of many successful profit-shifting structures that have allowed major MNEs to stockpile billons of low-taxed foreign earnings outside their home countries.

In the above example, it was assumed that when the research team within the US parent was to begin its project to further develop the intangibles, the US parent company owned only the

rights to exploit the existing intangibles within the US while the foreign subsidiary already owned the rights to exploit those intangibles outside the US. The point in noting this is that typically the US parent company will have originally owned all worldwide rights to the intangibles so that there may have been some prior transaction, such as a sale, by which a defined portion of the worldwide rights was transferred by the US parent to its subsidiary. Such a transfer, even if a part of the CCA agreement itself as a contribution by the US parent of pre-existing intangibles, is a transfer of intangibles that is governed with respect to valuation by the rules in the Actions 8-10 Final Reports, which include newly rewritten Chapter VI of the Guidelines. See the section above on "Intangibles" and the below quoted Paragraph 8.24 of new Chapter VIII regarding CCA contributions and balancing payments. It should be noted as well at this point that in determining the amount of each participant's CCA contribution, Chapter VI is also relevant in determining the value of the facilities provided by the US parent and the work performed by its research team. (See Example 4, Paragraph 18 in the Annex to Chapter VIII on page 180 of the Actions 8-10 Final Reports.)

Continuing with the example in the preceding paragraph, it will be appreciated that any sale or other transfer to a foreign subsidiary of valuable pre-existing intangibles, whether separate from the CCA or as a contribution under the CCA, must be examined under the domestic tax laws of both the parent and subsidiary countries. Any transfer might cause taxable income to be recognized at the parent-company level, or if the intangibles are transferred as a part of the CCA, the transfer likely creates balancing payments by the subsidiary to the parent that will have some tax effect to both parties. (See Paragraphs 8.41-8.43 on page 174 of the Actions 8-10 Final Reports.) As a result of this, and speaking generally, each MNE in setting up its foreign structures must decide how to make intangibles owned in the home country available to its foreign subsidiaries for their use. Should the MNE parent company transfer all or a portion of such intangibles to a subsidiary in a taxable transaction (whether separately or within a CCA agreement)? Should it transfer them to a foreign subsidiary in exchange for shares (which might or might not itself be a taxable transaction depending on the home country)? Or, should it license them and charge a royalty? If transferred through a taxable sale or in exchange for shares, then immediately upon completion of the transfer, the parent and the subsidiary will often execute a CCA covering future development for the intangibles. If the use of the intangibles is provided to the subsidiary through a license agreement, then there is no need for any CCA.

As will be appreciated, any decision on how to transfer intangibles will depend on many factors and there will be no one correct answer. This issue will be explored to some extent within class sessions and through the required case study.

It was noted above that CCAs have often been used by MNEs in profit-shifting structures. With the focus of the BEPS project on profit shifting that often involves transfer pricing abuses of intangibles, new Chapter VIII understandably includes a specific change to the CCA rules that is meant to prevent future BEPS structures. The perceived abuses come principally from situations where the MNE parent company has transferred intangibles to a new or existing foreign subsidiary in a zero or low-tax country and has then entered into a CCA with that subsidiary allowing the subsidiary to exploit any developed intangibles. For example, initially the parent in country A owns the worldwide rights to certain intangibles. The parent transfers to

the subsidiary the rights to exploit the intangibles throughout the world except for country A, the rights for which the parent has retained. From the date of the transfer, the parent and subsidiary execute a CCA with the subsidiary contributing only funding and the parent contributing continued development and enhancement of the intangibles. In some BEPS-motivated structures, the subsidiary may have no personnel of its own; it only sublicenses the intangibles to other group subsidiaries. Or, the subsidiary may conduct manufacturing to exploit the intangibles, but it only has personnel involved in manufacturing, none of whom are capable of exercising control over the various risks assumed under the CCA. (The concept of control is discussed above in the section on intangibles.)

In brief, to counter such BEPS-motivated structures, new Chapter VIII, Paragraph 8.15 (page 167 of the Actions 8-10 Final Reports) provides that a group member cannot be a participant in a CCA if does not exercise control over the specific risks it assumes under the CCA. In the case of a development CCA, this should normally be the development risks related to the intangibles that the participants hope to create through the CCA and the financial risks related to the anticipated cash contributions. If a group member is not a participant, then it would not be entitled to any share of whatever intangibles are developed under the CCA. As a result of this, the subsidiary in the above example, having no ability to exercise control over the various risks, would receive no share. See Example 5, Paragraphs 21-22 in the Annex to Chapter VIII on page 181 of the Final Report. See also Example 16 on pages 129-130 of the Actions 8-10 Final Reports. While Example 16 does not involve a CCA, its facts are closely related to the situation used in this discussion.

As a final point that acknowledges both the participants' contributions and balancing payments mechanics of CCAs, the following is from Paragraph 8.24 on page 170 of the Actions 8-10 Final Reports: "Contributions to a CCA may take many forms. For services CCAs, contributions primarily consist of the performance of the services. For development CCAs, contributions typically include the performance of development activities (e.g. R&D, marketing), and often include additional contributions relevant to the development CCA such as pre-existing tangible assets or intangibles. Irrespective of the type of CCA, all contributions of current or pre-existing value must be identified and accounted for appropriately in accordance with the arm's length principle. Since the value of each participant's relative share of contributions should accord with its share of expected benefits, balancing payments may be required to ensure this consistency. The term "contributions" as used in this Chapter includes contributions of both pre-existing and current value made by participants to a CCA."

The above discussion of CCAs assumes that all participants are members of a corporate group. While this is typically the case, CCA arrangements will sometimes be found where the participants are unrelated.

Business restructurings

The example in the above discussion of development CCAs alludes to certain existing intangibles (the rights to exploit certain intangibles outside the US) being owned by a non-US subsidiary of a US parent. How did it happen that that subsidiary came to own these existing intangibles? Of course, the subsidiary could have itself conducted R&D or it could have entered

into some earlier development CCA to develop those intangibles. Or, more likely, the US parent transferred in some manner a portion or all of certain of its intangibles to the subsidiary. Such an action to restructure intangible ownership within a group is one type of action that is referred to within the Guidelines as a "business restructuring". Other typical "business restructurings" are conversions of full-fledged distributors into limited-risk distributors or commissionaires acting for a related-party principal and conversions of full-fledged manufacturers into contract manufacturers or toll manufacturers that act for a related party. (See Section M.)

An important consequence of any business restructuring is that the apportionment of profits amongst the group members post-restructuring differs from what occurred pre-restructuring. The principal objective of the group in initiating a restructuring is often to shift profits to be earned in the future from a high-tax country into a low-tax country. Where intangibles are shifted to a tax effective location entity, future economic returns from those intangibles accrue within that low-taxed entity. A well-publicized example of this is Google's transfer of certain intangibles into an Irish subsidiary, resident in Bermuda. The above-mentioned conversions of distributors and manufacturers can accomplish the same goals.

As an example involving a conversion of a manufacturer, say that company X of country A has a subsidiary company Y in a high-tax country B that has been manufacturing certain products for a number of years using manufacturing intangibles that it acquired by license from X. Further, the products are primarily being exported from B for sale to X in A. In order to reduce the level of B tax on Y's substantial manufacturing profits, the two companies restructure their legal relationship although they make no changes in the activities and functions of employees in either company. In the process, Y is transformed from a full-fledged manufacturer operating on its own behalf into a contract manufacturer for X. X and Y terminate their existing licensing agreement and execute a new contract manufacturing agreement under which Y will produce products in accordance with X's specifications. Under the new agreement, X assumes full risk of inventory obsolescence and obligates itself to purchase all of Y's production output. Based on these changed circumstances, the new agreement provides that X will pay Y prices, based on a cost-plus pricing methodology, that are much lower than the prices previously paid by X for Y's manufactured products. Taking into account both the offsetting lower prices for its product sales and royalties it no longer pays to X, Y's taxable income falls significantly.

This sort of conversion for a manufacturing operation and similar conversions of distributors into limited-risk distributors and commissionaires has been an important part of "supply chain" planning that many multi-national groups are now using.

As will be appreciated, where a "business restructuring" occurs, the tax authorities in each relevant country will be concerned about two things. First, has an arm's length price been paid for any intangibles and other assets that have been transferred between group members in the restructuring? Second, does the post-restructuring transfer pricing between group members properly reflect arm's length principles? Chapter IX of the Guidelines focuses on these transfer pricing aspects of such internal group "business restructurings". Newly proposed language for Chapter IX was included in a 4 July 2016 OECD document for public review titled "Conforming Amendments to Chapter IV of the Transfer Pricing Guidelines".

Concluding comments – what to keep one's eyes open for

As a final brief comment in this transfer pricing section, one must be particularly alert to any situation involving related parties where value is being transferred from one related entity to another with inadequate consideration and/or documentation. Such transfers can create significant transfer pricing risks. While inadequate consideration will often be clearly seen where hard assets are involved (for example, say that fully depreciated but still high value equipment is transferred to a related company at book value), it will be less apparent with intangible assets such as goodwill, manufacturing know-how, the use of patents and designs, marketing intangibles, etc. Often, intangible assets, despite their very real existence, are effectively invisible due to their not being included on the financial statements or within the books and records of their owners.

One simple and common example involving intangible assets arises when a company X in country A establishes a new wholly-owned subsidiary Y in country B and relocates certain of its existing employees to B to work directly for Y. These employees carry with them knowledge of X's business and how to use any intangibles, especially know-how and trade secrets, that X may own. Assuming that X and Y have not entered into any license agreement allowing Y the use of X's intangibles, an analysis might reveal that Y was using valuable intangibles owned by X (e.g. patents, know-how, etc.). Depending on the situation, it is possible that the country A tax authorities could maintain that X had transferred ownership of certain intangibles to Y in exchange for an arm's length selling price (i.e. represented by the value of the shares of Y issued to X in connection with the establishment of Y), necessitating recognition of gain by X as of the date of transfer. Or, alternatively, they could maintain that Y should pay an arm's length royalty. There can, in some countries, be a risk that the country B tax authorities will maintain that the value of any intangibles received by Y represent taxable income since no shares were specifically issued by Y to "pay" for these assets.

T. Cross-border transfers of personnel

Introductory comments

Many multi-national corporate groups freely transfer personnel from one country to another for varying time periods and purposes that include management, technical support, training and development, and projects. Numerous issues arise from such transfers. These can include:

- Work permits/training visas in the host country

- Personnel policies to be applied to various categories of transferees (e.g. short term training assignments, short term work assignments, long term transfers) and the benefits that each is to receive (e.g. reimbursement of travel and moving expenses, incentive bonus, housing benefit, cost of living allowance, cost of children's education, home leave, hardship allowance, tax protection/equalization, pension/retirement coverage, etc.)

- Legal structuring of the employment relationship (e.g. continued employment of the transferred employee with his current group entity employer, cessation of the employee's current employment and establishing a new employment with the host country entity, transfer to an international manpower group entity, establishment of a dual employment status, etc.)

- Legal structuring of the personnel's status within the host country (e.g. employee of host country entity, employee within a branch of the overseas employer, employee within an unregistered branch of the overseas employer, secondment (see below), etc.)

- Continued taxation of the individual in the *home* country including withholding responsibilities of the employer and social insurance coverage

- Taxation of the individual in the *host* country including withholding responsibilities of the employer and social insurance coverage

- Taxation of the employer of the transferred personnel in the host country (i.e., where the personnel do not become direct employees of the host country entity)

- Legal structuring of incentive compensation including equity-based compensation including, where relevant, inter-company agreements placing the cost in the entity that received the benefit of the employee's services

- Continued coverage or alternative coverage of the individual under employer provided pension or superannuation arrangements

- Social security coverage issues both in the home and host countries

While a detailed discussion of these issues is beyond the scope of this course paper, a few brief comments should be made.

Potentially high tax cost on transferred personnel

First, when an employee makes a long term transfer, three aspects can cause a significantly higher level of personal taxation as compared to what would have been his level of taxation had the employee remained in the home country. Especially for higher compensated management personnel, the extent of this higher cost can make up-front planning to minimize it very important. These three aspects are:

- The tax rate in the host country may be higher than that in the home country.

- As the transferee is typically paid additional allowances during his assignment in the host country, the taxation base is higher.

- Where the employer agrees to pay or reimburse the transferred employee for any excess tax costs (see below), there can be a pyramiding of tax imposed on tax (often

referred to as “tax-on-tax”). The amount paid or reimbursed by the employer to offset the employee’s excess tax costs becomes additional income to the employee and that causes additional taxation on the individual. It is an upward spiral.

The combination of the additional allowances plus the extra tax cost on the employee that the employer sometimes agrees to bear means that in some host countries the actual cost to the employer of a transferred employee is as much as two, three, or more times the employee’s normal base salary and bonus.

Tax protection/equalization arrangements

The above-mentioned potentially high personal tax costs on transferred employees mean that many companies provide in their personnel policies for such transferred employees some form of tax equalization or tax protection for excess tax costs. In brief, under such arrangements, employers bear the excess of any actual income taxes assessed in the home and host countries over what the employee would have paid in the home country had he remained in the home country with only his base salary and bonus. This latter amount representing a home country tax calculation on only salary and bonus is often termed a “hypothetical tax” or “stay-at-home tax”.

Say that the calculated hypothetical tax for an employee in year 1 is 100 and his year 1 actual tax obligations to his home country and his host country are, respectively, 80 and 90. The employer will reimburse to the employee the difference of 70 (80 + 90 – 100). And this 70 will be additional compensation that causes 70 of additional personal taxable income and additional tax (the above-mentioned “tax-on-tax” pyramid).

In a tax equalization arrangement, the employee typically bears the hypothetical tax no matter whether his actual taxes are above or below the level of his calculated hypothetical tax. Thus, even if the actual tax costs are lower than the hypothetical tax, the employee will economically bear the hypothetical tax by paying back to the employer any difference. For example, if the hypothetical tax is 100 and the actual taxes paid to the home and host countries total 90, then the employee will pay 10 back to the employer. This payment of 10 will normally reduce the employee’s compensation and personal taxable income. This sort of personnel policy has organizational benefits since all transferred employees will be treated the same, no matter whether they are working in a high-tax host country or a low-tax host country. As such, for example, an expatriate employee working in a low tax location like Hong Kong will not be economically worse off from a higher personal tax cost if the employer wants him to relocate to a high tax country like Japan.

In a tax protection arrangement, typically the employee would not make any payment to the employer in the event of a low actual tax. Instead, the employee would retain the benefit of any situation where the actual taxes are lower than the hypothetical tax. Thus, in the above example, the employee would retain the benefit of 10. And from a human resources perspective, employees located in different countries are not being treated the same. The employee in the example has effectively higher compensation by 10 than a similar employee located in a high-tax country. As such, if the employer asks him to relocate from his current low-

tax host country to a high-tax host country, he will lose the benefit of that 10. And that loss may cause him to reject the transfer unless his compensation is increased.

An important point of the above several paragraphs is that how employees are equalized or protected from potentially high personal income taxes has not only employer cost considerations, but also human resources concerns.

Incentive compensation

An area of potential complication that requires careful planning and consideration is incentive compensation. Incentive compensation is very broad and can range from a simple performance bonus to equity-based compensation such as share options, phantom-shares, restricted shares, etc. Issues arising from incentive compensation can include:

- Multiple-country individual income taxation. Incentive compensation sometimes results from services physically performed in more than one country, each of which may have a claim to tax a portion of that compensation. The home country and/or the host country where an individual is tax resident may also claim taxing jurisdiction even if some or all of the relevant services were performed in other countries. Adding to the potential complexity are the employer and employee compliance responsibilities in each country over the life of the incentive compensation award, a period of time that can potentially span a number of years.

- Charging of incentive compensation cost to various entities that benefited from the employee's services. As incentive compensation, especially when equity-based, may have been earned over a multiple-year period, how to allocate the cost to the various group member companies that benefited may require some judgment. In addition, there may be practical difficulties in charging the cost to some group members where there are not already in place adequate inter-company service agreements that provide a legal basis for the charge.

  Charging the cost of equity based compensation involving grants on or options over the shares of the group parent to a group host company benefiting from the employee's services, whether or not that individual is an employee of the host company, raises issues of what amount charged will be locally deductible to the host company. Potential non-deductibility of such charges is an additional possibly material cost consideration.

- Personnel policy issues. Because of the unpredictability of the amount of incentive compensation and the locations where it might be earned, the potential individual tax costs on the individual employee can vary widely. Further, some forms of incentive compensation might not be deductible to the employer or other group member company benefiting from the services. Where taxation costs might be prohibitively high, personnel policies will sometimes provide for altered arrangements meant to control the tax costs of incentive compensation. Such provisions could change the basis or timing of the incentive compensation so as to avoid taxation in certain high-tax countries. Especially for highly compensated executives, tailored planning can be very important.

The above issues may also be relevant for employer provided pension or superannuation arrangements.

It should be noted in regard to stock options that the worldwide economic downturn that accelerated in the second half of 2008 and early 2009 caused many stock options held by employees to go "underwater". With the volatility of the world economy and the equity markets, this could happen again in the future. In any situation like this where previously granted stock options no longer represent meaningful employee incentives, employers may consider whether to modify the options or change compensation arrangements in some manner. For example, if an employer does decide to take some action, they might choose any one of the following:

- Replace or modify existing stock options to lower the exercise prices from their now unrealistically high levels to the current lower fair market value of the employer's shares

- Replace "underwater" stock options with restricted stock awards

- Replace "underwater" stock options with cash awards

The issue is that any decision to modify compensation arrangements such as underwater stock options requires a careful analysis of how the anticipated changes might affect the individuals' and employer's tax liabilities in the countries where personnel work and not only the tax effects in the home country of the employer. For example, if the mere granting of a stock option creates income in a country, the replacement of a now underwater option may create both increased taxable income to the individual and increased tax equalization costs to the employer. It would be unlikely that any "loss" to the employee from the cancellation of the previously granted option would be a deductible item.

Secondment

As a final issue, it is important to again mention the concept of "secondment", which was briefly covered in Section M above. Secondment typically refers to an arrangement under which a transferee remains an employee of and on the payroll of his existing employer (or sometimes on an international manpower group entity) and subject to all personnel policies and benefits of his existing employer (or where applicable of the manpower entity). Within the host country entity, the transferee's services benefit solely that entity's business and not the business of his legal employer, except in an indirect sense. As a simple example, say that X, established in country A, manufactures a product in its home country and sells to a distributor in country B. As a result of certain technical support requirements due to the nature of the product, X sends one of its experienced employees E to B to work under the supervision and control of the distributor in support of the distributor's customers. E remains legally an employee of X and subject to X's personnel policies and retirement plans. X continues to pay E's salary. The distributor reimburses X for E's employment costs.

Many host countries recognize the "secondment" concept and do not attempt to tax the employer in any manner due to the presence of the employee. These host countries accept that

the overseas employer does not have a permanent establishment or other taxable presence due to the physical presence of the transferred employee. The rationale for this is normally that the transferee is working under the supervision and control of, and his activities benefit directly, the host country entity. As such, these activities do not represent the conduct of the overseas employer's business. Such host countries typically allow most or all employment costs (i.e., salary and allowances) to be charged to the host country entity so that a local deduction is achieved for these costs. The transferee is subject to host country individual taxation. (See brief discussion of one aspect of secondment in paragraph 37 of Part III of the 2002 Report Related to the OECD Model Tax Convention, No. 8, Organisation for Economic Co-Operation and Development, 2003. See also discussion of employment relationships in the Commentary under Article 15 of the OECD Model Tax Convention, paragraphs 8.1*ff*. Finally, see discussion in item 7 beginning on page 15 of the OECD Revised Public Discussion Draft concerning "Interpretation and Application of Article 5 (Permanent Establishment) of the OECD Model Tax Convention", 19 October 2012.) (Note that as of late 2016, the various changes proposed in this Article 5 Discussion Draft have not yet been inserted into the OECD Model Tax Convention. An OECD release dated 16 July 2014 announcing the 2014 update to the Model Tax Convention stated: "The 2014 Update also does not include any of the changes put forward in the discussion draft of 19 October 2012 on Revised proposals concerning the interpretation and application of Article 5 (Permanent Establishment); since it is expected that work on Action 7 (Prevent the Artificial Avoidance of PE Status) of the BEPS Action Plan will result in changes to Article 5, the proposed Commentary changes included in that discussion draft will not be finalised until the work on Action 7 has been completed.")

U. Inflationary environment

Most of us have grown up within countries having relatively stable currencies. In the context of this discussion, this means that the rate of inflation has been sufficiently low that we are comfortable to hold balances of locally denominated currency. We are not worried that such currency will lose value so fast that we must buy something today rather than wait until next week, or next month when the same item will be much more expensive in local currency terms.

While many countries have had relatively stable currencies for many years, there have been some countries that have experienced periods of chronic inflation. This writer lived and worked in Russia during its inflationary period of the early to mid-1990s and Turkey during its economic problems in the 2000 to 2001 period. In both cases, the respective local currencies inflated significantly, causing the value of the local currencies as reflected in foreign currency exchange rates to fall continuously in relation to the value of "hard currencies" (e.g. the US dollar, the UK pound sterling, and the Euro). For example, in mid-1992 shortly after the collapse of the Soviet Union, the ruble:US dollar exchange rate was roughly 80 rubles to $1. By mid-1999, the exchange rate was about 25,000 rubles to $1. (For comparison purposes, the latter rate does not reflect the 1998 redenomination of the ruble when the last three zeros were eliminated.)

Even though a country may be experiencing high currency inflation, local transactions are typically still made in the local currency. (An exception to this was in Russia when many vendors started to post prices in US dollars in the early 1990s although payment was legally

required to be in the ruble as the only legally acceptable local currency. Later, new government rules prohibited this, requiring all prices to be posted in rubles.) And taxpayers' books and records and tax filings are all made in local currency. This being the case, consider how an annual tax filing will be affected when the year's taxable income includes both 100 rubles for the sale of one widget in January and 900 rubles for the sale of an identical widget in December. Ignoring all costs of sales and other expenses for simplicity and assuming that these two sales are the only transactions for the year, this results in 1000 rubles of annual taxable income. And with a 25% tax rate, the tax will be 250 rubles. Now say that the 250 ruble tax will be paid in May of the following year.

Now assume that this Russian taxpayer is a locally established company owned by a US parent. The US parent reports for financial accounting and for tax purposes in US dollars. Say that the Ruble:Dollar exchange rates are as follows:

January	1:1
December	9:1
May (following year)	15:1

With these exchange rates, the ruble transactions have the following values in US dollar terms.

January sale	US$100.00 (100 rubles ÷ 1 ruble/1 dollar)
December sale	100.00 (900 rubles ÷ 9 rubles/1 dollar)
May tax paid	16.67 (250 rubles ÷ 15 rubles/1 dollar)

As can be seen, although the nominal Russian tax rate is 25%, the effective tax rate on the income in US dollar terms has fallen to 16.67%.

What is the effect if the 250 rubles of tax can be paid not in May of the following year, but in December of that following year when the exchange rate has fallen further to 25:1? In that case, the US dollar value of the tax paid is US$10 (250 rubles ÷ 25 rubles/1 dollar) and the effective tax rate has fallen to 10%. This can have an important effect on the parent's reported earnings since the US$6.67 difference will mean higher after-tax earnings (ignoring for simplicity any accrual of US income tax that would arise upon repatriation as dividends of the Russian company's earnings). As the US has a deemed-paid foreign tax credit mechanism, how to translate the 250 rubles of tax paid for the parent's foreign tax credit computation is another issue.

Now consider several other issues that can arise where there is chronic inflation.

Consider the manner in which a taxpayer holds assets and incurs liabilities and how that can have a significant effect on its effective tax rate in that country. For example, unless the inflationary country concerned has rules that counteract this, when hard currency cash (e.g. the US dollar, Euro, etc.) is held (in cash or in a bank account), as the local currency falls in value, there is taxable gain on the hard currency in the local currency books. As an additional example, as inventory is purchased and held for a period of time prior to its sale, some portion of the local profit as measured in local currency will represent inflation rather than real economic

gain. Say that inventory is purchased on January 1st and the price paid to the supplier is 100,000 local currency units ("LCU"). At that time, say that the exchange rate with the US dollar is LCU100 per US$1 so that the cost of the purchased inventory in US dollars is US$1,000. Later, after the currency has inflated by 100%, the inventory is sold for LCU200,000. Assume for simplicity that this local inflation has caused the exchange rate with the US dollar to fall to LCU200 per US$1. In US dollar terms, this means that the inventory has been sold for the equivalent of $1000. So, assuming the US dollar is economically stable, there has been LCU100,000 of gross profit as measured in local currency while there has been no real economic gain. In such a situation (and assuming there is no local tax rule to counteract this), the LCU100,000 of gain will be taxed in the local country. Say that the local tax rate is 30% so that the actual tax paid is LCU30,000. Assuming that tax is paid when the exchange rate is still LCU200 per US$1, then the amount of tax paid in US dollars is US$150. Economically, there has been a loss equal to this US$150 in value of tax paid.

Similar issues can arise with the purchase of fixed assets where the future depreciation charges based on the historical local currency cost have a depreciated value. For example, using the above LCUs, say that a machine is purchased for LCU1 million on January 1st so that the cost basis in US dollar terms is US$10,000 (LCU1 million ÷ LCU100/1 dollar). For simplicity, assume that the full LCU1 million is later allowed as a depreciation deduction at a time when the exchange rate with the US dollar has fallen to LCU200 per US$1. That depreciation deduction will only represent a hard currency measured deduction of US$5000 (LCU1 million ÷ LCU200/1 dollar). And this of course economically overstates local taxable income. Planning in such a situation might suggest having the foreign parent (or a related foreign group member) acquire the machine and then lease it to the local subsidiary with lease payments contractually denominated in US dollars. In this way, as lease payments are made, the rental deduction in local currency terms will rise with inflation and deterioration of the LCU/US$ exchange rate. And with this higher local currency rental deduction, the local subsidiary's taxable income will not be overstated as it would be with the above depreciation that is based on the machine's historical local currency cost basis.

It should be added that tax loss carryovers in inflationary countries are normally not indexed for inflation. As such, only the depreciating-in-value local currency losses are carried forward. Accordingly, it is typically critical in such countries to avoid tax losses and, where incurred, to utilize them as quickly as possible.

It is also necessary to take into account the potential beneficial effect of strategies that allow for a delay of any tax payment. (See above situation where the 250 ruble tax payment was delayed from May to December.) Where a tax can be paid with "cheaper" local currency units tomorrow instead of with more expensive local currency units today, that generally provides a significant benefit that can reduce the effective tax rate on the economic income as measured in hard currency terms. On the other hand, some countries with high inflation have enacted high interest and penalty rates on delayed tax payments to counteract this loss of value from any delay in the payment of a tax. Attention to how interest charges relate to currency devaluation rates will be particularly important.

V. Exchange and translation gains and losses, exchange controls, investment approvals, and blocked currencies

Exchange gains and losses

Exchange gains and losses normally arise from changes in the relative values of assets and liabilities that are denominated in a currency other than the currency of the country imposing tax. As an example of a typical situation where an exchange gain or loss may arise, say that a Singapore company has a customer receivable that is denominated in US dollars. If the US dollar rises in value against the Singapore dollar, then there will be an economic gain as measured in Singapore dollars. If the US dollar falls, then there will be a loss in Singapore dollars. Correspondingly, if the Singapore company has borrowed from a bank with the loan being denominated in US dollars, then a rise in the US dollar against the Singapore dollar will increase the amount owed in Singapore dollar terms. And that will be an exchange loss to the Singapore company. And if the US dollar falls in relation to the Singapore dollar, then the opposite occurs.

What are some examples of assets and liabilities that can be denominated in a currency other than the home country currency? The most common examples include bank accounts, accounts receivable and payable, refundable deposits, investment securities such as bonds that have a fixed principal amount, and bank loans and other liability accounts. And what are some examples of assets and liabilities that are not denominated in any currency and therefore do not cause any exchange gains or losses? Common examples include inventory, fixed assets and investments in equity securities.

Using the above example of the Singapore company that holds a US dollar receivable, say that the receivable arose from a sale of widgets that the Singapore company made to a customer on December 1st for US$10,000 and that the customer paid the US$10,000 two months later as promised on February 1st of the following year. Assume the following exchange rates:

December 1st	S$1.50:US$1
December 31st	S$1.40:US$1
February 1st	S$1.60:US$1

A first issue involving exchange gains and losses is their timing of recognition in taxable income. Where a country recognizes this gain or loss only at the moment when there is a realization event, then this gain or loss will be locked in and accounted for as of the date of that event. In this example of the US dollar receivable, the Singapore company on December 1st recognizes the revenue from the sale as S$15,000 (US$10,000 x S$1.50:US$1). Since we are first assuming that recognition only occurs upon a realization even, nothing is recognized at December 31st. Then, upon receipt of the customer's US$10,000 February 1st payment, the Singapore company will have received in Singapore dollar terms S$16,000 (US$10,000 x S$1.60:US$1). Because the original sale was accounted for at S$15,000, there is a S$1000 exchange gain recorded on February 1st.

Now assume that a mark-to-market method is applied. Again, the Singapore company recognizes sales revenue of S$15,000 on December 1st. However, on the December 31st balance sheet date when the Singapore dollar has gained in value against the US dollar, the Singapore dollar value of the US$10,000 is only S$14,000 (US$10,000 x S$1.40:US$1). Under the mark-to-market method, this S$1000 loss is recognized on that date. On February 1st when the customer pays the US$10,000 owed, the Singapore company will have received in Singapore dollar terms S$16,000 (US$10,000 x S$1.60:US$1). As such, the S$2000 difference from the December 31st value will be recognized as exchange gain on that payment date.

A second issue is the classification of an exchange gain or loss as being revenue (i.e., ordinary) or capital in nature. This classification may be particularly important under a country's taxing system if it treats each type differently. Japan and China are examples of countries where this classification normally makes no difference since there is no revenue-capital distinction for a corporate taxpayer when calculating taxable income. On the other hand, both the US and Singapore are examples where there is a clear distinction between gains of revenue and capital nature. Typically, if a gain or loss is revenue in nature, then it is generally fully included in the taxable income calculation. If capital in nature, then net gains may be taxable at a different rate or may be fully tax-free. And net losses might receive no current tax benefit.

In making the distinction between revenue or capital nature for any specific exchange gain or loss, the local rules and practices in each country would have to be reviewed. As a simple example, though, some countries treat exchange gains and losses on customer receivables and trade payables as revenue while those on investments such as bonds and on long-term liabilities such as long-term debt are treated as capital.

It is important for a multi-national group to monitor these types of situations generally and inter-company receivables and payables in particular in order to avoid to the extent possible potential whipsaw effects from both timing and classification differences. For example, situations should be avoided that might cause a non-deductible foreign exchange loss in one subsidiary that is economically offset by a taxable gain in another group member.

Translation gains and losses

In contrast to exchange gains and losses, translation gains and losses arise when an entire balance sheet and income statement must be restated in another currency. For example, a resident of country A may maintain an operating branch in another country B. That branch maintains its own accounting records and prepares a branch balance sheet and income statement denominated in B's currency. When the resident prepares its A tax filings and includes the branch accounts, it will have to translate those branch accounts into A's currency. There are various approaches to making the translation that can produce varying results. For example, one approach might convert liquid balance sheet assets and liabilities at the year-end exchange rate but fixed assets and capital accounts at historical rates (i.e., the exchange rate at the date of each fixed asset purchase or issuance of capital). The income statement might be translated at an average rate for the year but with depreciation and amortization charges being calculated at the historical rates. Another approach might ignore historical rates.

When a translation is made, the gain or loss that results may be either currently recognized in taxable income or deferred in some manner under A's rules. In addition, as with exchange gains and losses, translation gains and losses can potentially be separated into revenue or capital components.

Exchange controls

The effects of exchange controls and their requirements are an important element of planning international business investment and transactions. While these rules in many countries might not actually inhibit the movement of funds either into or out of the country, such fund movements may require timely filings and sometimes pre-approvals. On occasion, failing to make required filings or obtain pre-approvals can mean substantial penalties or even confiscation of the funds moved. One unexpected issue that can arise with some countries is that a foreign person making a loan to a domestic borrower (whether related or unrelated) must make notification of the borrowing or secure pre-approval. In the absence of such, the repayment of the loan and payment of interest to the foreign lender may be prohibited. Similar requirements will often apply to capital investments. China maintains various capital investment rules and exchange controls that effectively prohibit loans. This can create a "trapped cash" situation where excess cash generated from operations, but which for various reasons might not be distributable as dividends, cannot be simply loaned to other group members, whether inside or outside of China. This means that upfront planning of a new Chinese subsidiary's capital structure to allow the maximum amount of repayable debt can be particularly important.

In late 2016, news reports surfaced that China was strengthening its exchange controls due to national foreign exchange concerns. This had the effect of prohibiting or making it more difficult for some Chinese subsidiaries of foreign parents to approve certain payments, such as those for dividends or loan repayments. Although news reports quoted the European Union Chamber of Commerce in China as saying that complex approval procedures for sending money out of the country were introduced in late November and have been "disruptive to EU companies' regular business operations", a question and answer posted on China's State Administration of Foreign Exchange website stated, in part:

> … Foreign exchange authorities have not taken any new regulatory measures for currency exchanges or cross-border receipts and payments thus far, except to require banks to observe the existing foreign exchange regulations, implement the self-regulatory requirements and intensify authenticity and compliance reviews. The foreign exchange administration policies remain consistent with the previously published ones, with no change made. The foreign exchange purchase, payment, receipt and settlement are handled as usual. … [From http://www.safe.gov.cn/wps/portal/!ut/p/c5/04_SB8K8xLLM9MSSzPy8xBz9CP0os3gPZxdnX293QwP30FAnA8_AEBc3C1NjI3czI_1wkA48Kgwg8gY4gKOBvp9Hfm6qfkF2dpqjo6IiABQXMys!/dl3/d3/L2dJQSEvUUt3QS9ZQnZ3LzZfSENEQ01LRzEwT085RTBJNkE1U1NDRzNMTDQ!/?WCM_GLOBAL_CONTEXT=/wps/wcm/connect/safe_web_store/state+administration+of+foreign+exchange/safe+news/fd5ba5004f62232a9365bf7a2f88d547]

The point of raising this Chinese development is that although foreign exchange has generally become less and less of an issue in international business and investment, it is still a risk that must be recognized and planned for where possible.

Investment approvals

Some countries maintain various investment and anti-monopoly rules that require notification or pre-approval of investments or other defined transactions.

Blocked currency

While becoming less common, some countries restrict the ability of an investor to repatriate earnings. Where such rules are relevant, planning to minimize their effects is important.

W. Laws and Rules

What are the typical tax laws and types of taxes that are found in many countries? These include:

- Corporation income tax
- Individual income tax
- Withholding taxes on foreign persons
- Value added tax (see description of Japanese Consumption Tax on Course Website)
- Gross sales based taxes (including "turnover taxes" assessed as a percentage of price or at a fixed rate per volume/unit of product)
- Resource taxes (i.e. similar to royalty on minerals extracted)
- Import and export duties
- Excise taxes
- Stamp duties
- Capital taxes (on equity capital or on specific categories of property)
- Capital registration charges (i.e. on issuance of shares)
- Real estate transfer taxes
- Payroll taxes including social insurance and unemployment charges

- Gift and inheritance taxes

- Wealth taxes

Countries normally view a partnership for taxation purposes either the same as a corporation or as a transparent entity with only the partners being taxed and the partnership itself not being taxed or even filing any reports.

X. Factors affecting business decisions

Any decision on whether to implement a particular planning idea or transaction structure is a result of the weighing of a number of business, legal and tax factors. From the tax and administrative perspectives, these factors can include the following items. As you scan through them, recall the short section headed "Being aware of motivation" and consider how the motivation might affect your thinking about some of these factors.

- Overall character of organization and company management—conservative/aggressive/ willingness to accept tax risk and the expanded business risks that can arise in today's environment

- How easy administratively, how much disruption to the business and its operations, what effects arise from implementing the desired planning?

- Administrative simplicity versus complexity of living with a new structure in the future and commitment to maintain and monitor the new structure

- Does the planning affect "real" operations (e.g. do operating personnel have to change their operating procedures or do the contractual or actual relationships with suppliers or customers have to change) or is it only seen "on paper" with no effective actual or legal changes?

- Likelihood that future changes in tax law will require a change in the model

- Evaluation of risk versus benefits

- Communication skills of outside advisors and external and in-house counsel who must make the ideas understandable to the company's decision-makers

- Existence of oversight laws such as the Sarbanes-Oxley legislation in the US

THE BEPS PROJECT – A PRIMER WITHOUT THE GORY DETAILS

Introductory comments including examples of BEPS activities

From an overall perspective, governments throughout the world have been losing many billions of dollars of tax revenues for two principal reasons. The first is illegal tax evasion, principally by wealthy individuals who place funds, undeclared to their local tax authorities and sometimes illicitly obtained, in overseas banks, tax haven companies, trusts, and other structures. The second reason is the "legal" tax avoidance conducted by many multinational groups (MNEs) through aggressive structuring of operations and transactions that often lack economic reality so as to earn profits that are subjected to zero or low-taxation. While technically "legal", such tax avoidance is typically inconsistent with the purpose and intention of applicable tax laws and tax treaties.

The Base Erosion and Profit Shifting (BEPS) project, which is the subject of this section and which took place over the two-year period from 2013 to 2015, is focused solely on the second of these two reasons. Other international and country-specific programs seek to reduce the tax losses from illegal tax evasion.

This discussion of the BEPS project is intended to give the student an understanding of the project's origin, its objectives, and how it may proceed in the future. It does not attempt to summarize in detail the specific results of the work on the project's 15 Action Plan items. Rather, only some brief comments are made on them to provide a flavor of the BEPS work undertaken by the OECD and the others who participated in this project. Students are encouraged to scan or read through both the "Executive Summaries 2015 Final Reports" (available at http://www.oecd.org/ctp/beps-reports-2015-executive-summaries.pdf) and the individual Final Reports on the Action Plan items (all are available at http://www.oecd.org/ctp/beps-2015-final-reports.htm). Another useful resource is the OECD's BEPS Frequently Asked Questions webpage (available at http://www.oecd.org/ctp/beps-frequentlyaskedquestions.htm).

To assure some common understanding for the following discussion, BEPS activities as typically conducted by MNEs may include any of the following:

- Shifting profits through the use of supply chain business models that place the bulk of profits into a zero or low-taxed "entrepreneur" subsidiary that either owns or holds rights to valuable intangibles and that assumes all benefits and commercial risks while other group members that conduct R&D, manufacturing, and distribution are compensated on a service fee basis that reflects a low level of commercial risk.

- Transferring valuable, but hard to value, intangible property (patents, copyrights, trademarks, etc.) between group members via sale, license, and/or cost contribution agreement mechanisms at artificially low prices so as to allow relatively higher profits from the intangibles or from the exploitation of those intangibles to be earned within zero or low-taxed group members. Exploitation can include the manufacture and sale of products based on the intangibles and licensing of the intangibles to unrelated persons.

- Breaking up group activities amongst group members in multiple countries, each having some differing taxation characteristics, and then skewing the transfer pricing between the group members so as to maximize income in zero and low-tax locations. In some such cases, the transfer pricing used will have little or no commercial justification.

- Structuring local sales and product support, warehousing, and other distribution functions through service companies so as to avoid creating taxation on sales income within the countries where customers are located. This can also include the use of commissionaire arrangements so as to effectively maintain local sales agents without creating any local taxable presence or permanent establishment of the foreign seller.

- Maintaining digital platforms and structuring digital transactions so that profits are earned by a group member within a zero or low-tax jurisdiction, thereby avoiding any tax in either the MNE's home country or in the countries where other parties use or access the digital platform. Such digital transaction revenues can include sales and rental of digital products both created by the MNE and purchased from third parties, commission income from selling or renting third-parties' hard and soft products via digital platforms (e.g. apps, music, books, etc.), advertising receipts from providing advertisers with access to digital platform users (who are typically not charged for their use of the digital platform), and services income from providing cloud-based services. While much structuring is directed at the avoidance or minimization of corporate income taxes, avoidance of value added taxes may also be a feature of such structures.

- Structuring group members and their transactions so as to take advantage of benefits offered by some countries that have the "spillover" effect of undermining the tax bases of other countries. These have sometimes been labeled as "harmful tax practices". Examples can include the inappropriate use of some incentives such as certain patent box regimes. MNEs use Ireland, Luxembourg, and other countries imposing little or no tax that facilitate structures, sometimes with private rulings and often involving interest and royalty payments. The MNE is arguably allowed to avoid PEs in other countries or to access treaty networks that reduce the level of withholding taxes. These mechanisms typically allow low-taxed profits within the group member that are disproportionately high in relation to the level of real economic activity conducted by that group member.

- Structuring interest, royalty, management fees, and other intercompany charges by contractual agreements that reduce income in countries where operations are conducted.

- Capitalizing subsidiaries so as to maximize interest-bearing debt and minimize equity capital, often causing there to be in the aggregate significantly more debt (some or all of which creates deductible interest) than the total debt owed by all group members to third-party creditors and lenders.

- Using hybrid entities and instruments to achieve tax savings through two or more countries characterizing one entity, transaction, and/or item of income in varying manners.

- Structuring transactions indirectly through one or more intermediary countries so as to achieve lower withholding taxes on certain outbound payments available under tax treaties (i.e., treaty shopping).

The great success of many MNEs, no matter where headquartered, to reduce their effective tax rates has increased the financial pressure on governments around the world. The OECD in its 5 October 2015 "OECD/G20 Base Erosion and Profit Shifting Project Explanatory Statement" (available at www.oecd.org/tax/beps-explanatory-statement-2015.pdf) comments in paragraph 2:

> The stakes are high. Although measuring the scope of BEPS proves challenging, the findings of the work performed since 2013 confirm the potential magnitude of the issue, with estimates indicating that the global corporate income tax (CIT) revenue losses could be between 4% to 10% of global CIT revenues, i.e. USD 100 to 240 billion annually. The losses arise from a variety of causes, including aggressive tax planning by some multinational enterprises (MNEs), the interaction of domestic tax rules, lack of transparency and coordination between tax administrations, limited country enforcement resources and harmful tax practices. The affiliates of MNEs in low tax countries report almost twice the profit rate (relative to assets) of their global group, showing how BEPS can cause economic distortions. Estimates of the impact of BEPS on developing countries, as a percentage of tax revenues, are higher than in developed countries given developing countries' greater reliance on CIT revenues.

This pressure was strong enough that the G20 leaders in their Saint Petersburg declaration of 6 September 2013 strongly endorsed the BEPS project, saying:

> We fully endorse the ambitious and comprehensive Action Plan – originated in the OECD – aimed at addressing base erosion and profit shifting with mechanism to enrich the Plan as appropriate. We welcome the establishment of the G20/OECD BEPS project and we encourage all interested countries to participate. *Profits should be taxed where economic activities deriving the profits are performed and where value is created.* [Emphasis added.]

An Environment that Strongly Motivates BEPS Behavior—Systemic Issues and Developments Occurring over Past Decades

What is the background to this growth in MNE tax structuring that became so serious that G20 country leaders, who would normally eschew speaking of taxes, identified this as a major agenda item?

In brief, there are certain systemic issues, generally found worldwide, that have strongly encouraged the managements of many MNEs to seek opportunities to achieve low or zero taxation on major portions of their companies' income. There are also certain developments that have occurred over the past several decades that have had the effect of facilitating the profit shifting by MNEs that is presently so rampant.

Systemic issues include:

- Home Country Tax Systems that Encourage Profit Shifting. Existence of worldwide tax systems (often called deferral systems) and hybrid-territorial tax systems under which profits earned within certain legal entities established outside an MNE's home country will either not be currently taxed, or will never be taxed, by that home country.

- Separate Entity Principle. Acceptance by tax authorities and courts around the world of corporations and other legal entities as separate and independent legal persons, no matter where established and by whom owned.

- Tax-Motivated Intra-Group Structuring Having No Economic Significance. Ability of MNEs to contractually "break-up" their business activities by freely placing functions, assets (importantly including intangibles), and risks within both newly created member entities and existing member entities, all of which contract among themselves in any manner they please since the terms of such inter-company contracts will have absolutely no economic effect on the MNE group as a whole (aside from desired beneficial tax effects).

- Acceptance of Intra-Group Transactions and Documents. Despite the inherently non-arm's length nature of these inter-company related-party contracts that have been structured to a large extent to achieve profit shifting and other taxation goals, acceptance internationally of these contracts as legally enforceable by tax authorities and courts as long as they reflect some degree of commercial reasonableness, are legally enforceable agreements, and have been respected as such within the MNE (i.e. all contract terms being carried out by MNE group members and not ignored, which would cause the contract itself to be a sham).

- Arms' Length Standard. The arms' length standard in transfer pricing that by its nature causes some subjectivity in developing ranges of arguably acceptable pricing that spreads group profit among all the MNE group members and that is difficult and time consuming for resource constrained tax authorities to audit.

- Financial Reporting and Accounting Rules. Accounting principles (both IFRS and GAAP) that allow the lower taxes due to profit shifting to inflate corporate after-tax financial statement earnings, including where relevant the ability for MNEs headquartered in deferral home countries to accrue no future home country and other income tax (including withholding taxes) that would arise upon profit repatriation based on the MNE's intention to permanently reinvest those profits, thereby lowering financial statement effective tax rates and increasing reported earnings.

- Effect on Share Prices. Capital markets rewarding reductions in an MNE's effective tax rate and the resulting higher reported earnings through higher share prices.

- Conflict of Interest. MNE management personnel being personally motivated to minimize effective tax rates due to equity-based compensation plans based wholly or in part on share price (hence, a conflict-of-interest issue).

These systemic factors are not changeable in the short term. Countries are not likely to change from their deferral and territorial tax systems to other possible systems anytime soon. The corporation (including the LLC and some other legal forms) as a separate legal entity is a firmly-embedded fundamental pillar of legal and tax systems around the world. The various other factors above, including the last factor listed, which involves human nature, are equally integral parts of a worldwide environment that will not change anytime soon.

As noted above, in addition to these systemic issues, certain developments have occurred over the past several decades that have had the effect of facilitating and encouraging MNE profit shifting and other BEPS behavior. These developments include:

- <u>Proliferation of Hybrid-Territorial Tax Systems.</u> Going back ten to thirty years or more, many countries had deferral systems such as the U.S. and China have today under which earnings within foreign subsidiaries would be taxed in the home country when those subsidiaries paid dividends to the parent company. Over the past few decades, though, many countries changed their basic approach by abandoning their use of deferral systems and adopting hybrid-territorial systems under which such dividends would be tax-free (or substantially tax-free) upon repatriation to the parent company through dividends. This change heightened the incentive to push earnings out of both the home country and the countries where operations take place and/or revenue is earned and into zero and low-taxed subsidiaries since any earnings may be distributed as dividends with little or no further home country tax. The U.K. and Japan are the major countries that have most recently adopted hybrid-territorial systems.

- <u>Reduction in Tax Rates.</u> The U.S. lowered corporate and individual tax rates in the mid-1980s. Many other countries have not only followed the U.S. lead, but have far surpassed the U.S. in rate reductions. Previously, many MNEs paid high foreign taxes and had excess foreign tax credits. Such MNEs were able to generally minimize their home country taxation on dividends received through careful planning for utilization of foreign tax credits. As tax rates were lowered in many countries and territorial systems were adopted, often with limited or ineffective CFC rules, it became even more beneficial to MNEs to create income not subject to tax in any source or host country. For MNEs headquartered in territorial system countries, foreign tax credits often were no longer relevant. For MNEs headquartered in deferral system countries, many were often no longer in excess foreign tax credit positions, thereby causing home country taxes to be due upon dividend repatriation. This created the sometimes-called “lock-out effect” where deferral country-based MNEs (specifically U.S.-based MNEs) simply refused to repatriate foreign earnings unless absolutely necessary. All this strongly encourages MNEs to avoid source and host country taxation to the greatest extent possible since any such taxes paid would never be used as tax credits against the MNE’s home country tax.

- <u>Elimination of Restrictions on Cash Movement.</u> The elimination by most countries of exchange controls and other restrictions on the movement of cash has allowed many MNEs to set up central treasury operations that allow more efficient use of the cash balances held by MNE group members. Before such central treasury operations were set up, especially when many countries still had exchange controls or other restrictions, the payment of dividends was often necessary to allow other group members to use the cash generated from a subsidiary’s profitable business operations.

- Development of Supply Chain and Other New Business Models including Advances in Information and Communication Technology. As businesses expanded internationally in the post-WWII world, the business environments and communication technologies of the time generally required that overseas manufacturing and other business operations be conducted on a stand-alone basis with each operating subsidiary having its own management team locally directing sales, operations, finance, and other functions. Further, unless there were local equity participation requirements, such subsidiaries were typically wholly owned.

  Starting from the mid-1980s, some MNEs began moving portions of their domestic manufacturing to Asia and, in particular, to China, a country that at the time severely restricted levels of foreign ownership and mandated the form that investments must take. This trend accelerated in the 1990s and especially after the turn of the Century. At that time in China, there were legal and practical difficulties that prevented MNEs from owning and controlling manufacturing operations on the Mainland. As a result, their competitive need for China's low-cost production forced MNEs to accept zero or minority ownership positions in the manufacturing operations that produced their goods. This use of uncontrolled contract manufacturers grew and MNEs became comfortable with these arrangements.

  This comfort level, along with advances in information and communications technology and shortened logistical time-lines, resulted in centrally managed supply-chains and other new business model structures that were markedly different from the previous stand-alone independently operated subsidiaries. Using these new business models as a basis, MNEs placed intangible rights and all commercial risks into "entrepreneur" subsidiaries, often located in tax havens. Operating subsidiaries, whether involved in production or in product distribution, were set up on a limited risk/limited profit basis, thereby placing the bulk of the profits in the zero or low-taxed "entrepreneur" subsidiary.

- "Selling" by Outside Advisors. Over the past several decades, outside advisors including law firms, accounting firms, banks, and others in the financial services industry have increasingly made a business of "promoting and selling" tax structures and techniques. This has included selling MNEs many of the common structures that the BEPS project has found to be so objectionable.

- U.S. Repatriation Tax Holiday. More recently, regarding U.S. MNEs, the 2004 repatriation tax holiday that applied to repatriated profits strongly encouraged U.S. MNEs to even more aggressively shift profits due to their hope that this holiday would be repeated.

Over the past few decades, these developments helped exacerbate the tax planning of MNEs and encourage them to establish increasingly aggressive profit shifting structures. As noted earlier, the increasing success of such efforts sufficiently eroded the tax bases of enough countries that the OECD member countries and the G20 finally decided to take action.

Participants in the BEPS Process

The BEPS project has been orchestrated by the OECD, which has a relatively limited membership of thirty-four countries. There has been, though, some participation by many non-members from developing countries. For example, it was reported that an announcement at a 10 October 2015 Beijing conference included the information that about 50 China State Administration of Taxation officials participated in the BEPS project and that China submitted over 1000 comments or suggestions to the OECD (see http://www.pwchk.com/webmedia/doc/635804313412398749_chinatax_news_oct2015_41.pdf). An OECD website page notes that over 80 developing countries and other non-OECD/non-G20 countries have had some participation (see http://www.oecd.org/tax/developing-countries-and-beps.htm).

Despite OECD efforts at broadening participation, there have been concerns expressed that the needs of developing countries have not always been appreciated or sufficiently reflected in the various discussion drafts and final reports. With respect to the future, the interest that the BEPS project has generated will encourage more active participation by not only more countries, but by more international organizations, each hopefully bringing their particular areas of expertise to the table. As of early October 2015, an OECD website noted that about 90 countries have indicated their plans to participate in the development of the Multilateral Instrument, which is the focus of Action Plan item 15.

People directly involved in the BEPS process were primarily OECD officials and member country representatives who generally are tax administrators within their respective home countries. A limited number of non-member country representatives were included as well. They set up various working groups to study different areas and then started looking at issues and ideas. It was a relatively open process from the standpoint of seeking outside comments on discussion drafts and having some working sessions to conduct face-to-face discussions with interested parties. In addition, there were webcasts to help disseminate decisions and results. While it was a relatively open process from the perspective of seeking outside input and informing the public, the actual decision making process of what was to be included in the discussion drafts and the final 5 October 2015 reports was relatively opaque.

Understandably, the working groups heard disproportionally from MNEs and the professional community (principally law and accounting firms) that are paid advisors to these MNEs. There was some limited participation by others, importantly including some civil non-governmental organizations that have become increasingly vocal over the past decade concerning the detrimental effects of BEPS activities on tax receipts and the resulting decreasing level of government services available to people in both the developed and developing worlds. One particularly active group is The BEPS Monitoring Group, which provided comment letters on all BEPS discussion drafts (see https://bepsmonitoringgroup.wordpress.com). One contributor to The BEPS Monitoring Group was Richard Murphy, the person who first suggested the need for country-by-country reporting over a decade ago (see http://www.taxresearch.org.uk/Blog/). The author of this paper (i.e., your instructor) also wrote or reviewed a number of comment letters issued by this group.

General Areas of Attention within BEPS Project

While this is a simplistic overview, the general areas considered included the following:

The Digital Economy (Action 1)

The conduct of business has been transformed by information and communication technology advances, creating new business models and changing the traditional ways that consumers and businesses purchase products and access services. The working group on this subject has produced an Action 1 Final Report of 290 pages identifying issues and alternatives in both the income tax and value added tax areas.

The principal conclusion of this Final Report is that the effects of information and communication technology are so pervasive throughout all sectors of today's economy and business activities that it is not possible to apply special rules to identified digital economy businesses. The Report states (page 142):

> Because the digital economy is increasingly becoming the economy itself, it would be difficult, if not impossible, to ring-fence the digital economy from the rest of the economy for tax purposes.

As a result, the working group took a "wait and see" approach by noting that many BEPS issues relevant to the digital economy would be dealt with, at least partially, under other BEPS Action Plan items. Under this "wait and see" approach, it was decided to develop a detailed mandate during 2016 to monitor future developments. These efforts will culminate in a report being issued by 2020.

The Final Report also notes (page 132):

> … the broader tax challenges raised by the digital economy go beyond the question of how to put an end to double non-taxation, and chiefly relate to the question of how taxing rights on income generated from cross-border activities in the digital age should be allocated among countries. …

In saying this, the Report is reflecting concerns that the digital economy sometimes allows a foreign taxpayer with no material physical presence in a country to generate significant income either from, or as a result of, users in that country. Income can be earned directly from the users or indirectly through business models that charge other parties such as advertisers fees for providing access to users. In these latter cases, the users of internet platforms are clearly seen to be adding value to the foreign taxpayer's business and are a factor that is crucial to the taxpayer's earnings.

While the Final Report specifically makes no recommendations on any possible changes to the allocation of taxing rights, it does encourage countries desiring greater taxing rights for digital economy income to enact provisions in their domestic law that would be applied to taxpayers

not protected by any tax treaty or where an otherwise treaty-protected taxpayer should be denied treaty benefits based on anti-abuse rules.

Hybrid Mismatch Arrangements (Action 2)

The working group on this subject has produced an Action 2 Final Report of 458 pages, almost three hundred of which is an appendix chock full of examples.

To make a long story short, the Final Report explains (page 11):

> Hybrid mismatch arrangements exploit differences in the tax treatment of an entity or [financial] instrument under the laws of two or more tax jurisdictions to achieve double non-taxation, including long-term deferral. These types of arrangements are widespread and result in a substantial erosion of the taxable bases of the countries concerned. They have an overall negative impact on competition, efficiency, transparency and fairness.

A simple example of a hybrid instrument is a preferred share that is treated by the country of the issuer as debt, but which is treated as equity by the country of the holder. The typical benefits to the parties of using such an instrument are an interest deduction to the issuer and exempt income in the hands of the holder.

A common example of a hybrid entity is a partnership or limited liability company that is a member of an MNE group and which is treated differently by various affected countries. The country of the business vehicle's equity owner might treat it as transparent so that it considers the equity owner the taxpayer that must report the vehicle's income and expenses. On the other hand, the country of establishment might treat the vehicle under its tax law as a normal corporate taxpayer. Another example is a company that is tax resident in more than one country. A hybrid entity structure might be used in connection with a financing to obtain a deduction for interest expense in two or more countries.

Hybrid mismatch arrangements provide significant, though unintended, economic benefits that represent an erosion of the collective tax bases of the countries concerned. Yet, the arrangements typically comply with the tax laws and practices of each applicable country. As a result, the Final Report notes the inherent difficulty of determining unequivocally which individual country has lost tax revenue as a result of the arrangement.

Given this situation, the Final Report provides a package of recommended treatments of such hybrid instruments and entities so as to eliminate the benefit of mismatch arrangements, thereby presumably discouraging their use in the future. While the concepts behind the recommended rules are simple, their actual use by each country involved in a taxpayer's hybrid instrument or entity will be potentially complicated and often require knowledge of how the transaction or entity is being treated by other involved countries. If taxpayers, who presumably know the details of their own transactions and entities, do not voluntarily apply these rules as enacted as part of the local law of each involved country, local authorities may have significant practical difficulty both in recognizing that an instrument or entity is a hybrid arrangement and in determining the treatment of the arrangement under the laws of other involved countries.

Implementation of the recommendations will require changes under domestic law and under tax treaties. It is expected that changes will be made to the OECD Model Tax Convention. Changes to existing treaties will be made through the mechanism of the Multilateral Instrument of Action Plan item 15. (See Part II of the Multilateral Convention to Implement Tax Treaty Related Measures to Prevent Base Erosion and Profit Shifting ("Multilateral Convention") released on 24 November 2016.) As adoption by individual countries into their domestic laws may be sporadic and take considerable time, it seems likely that such hybrid instruments and entities may continue for some period to be attractive BEPS tools for many MNEs.

Controlled Foreign Company (CFC) Rules (Action 3)

In general, CFC rules tax the parent of an MNE group (over which its country of residence has jurisdiction) on the calculated profits from certain defined activities or categories of income of foreign subsidiaries. The primary objective of such rules is to prevent the erosion of the home country's tax base by MNE's shifting of profits and assets into zero or low-taxed subsidiaries.

It has been recognized that strong CFC rules can discourage profit shifting and result in higher tax collections in both source countries and home countries. This is because any shifted profits out of both source and home countries are currently taxed in the home country. Where strong CFC rules accomplish this, MNEs will not normally waste their resources setting up complicated profit shifting structures, thereby resulting in higher reported income in both source and home countries.

Despite the obvious benefits of strong CFC rules, the Action 3 Final Report of only 75 pages reflects that fact that the participating countries could not reach agreement on any minimum standards for an effective CFC system. As a result, the Report simply gives guidance to countries interested in adopting or improving their existing CFC rules by providing what the Report terms the "six building blocks for the design of effective CFC rules".

Interest Deductions and Other Financial Payments (Action 4)

In contrast to above Action 3 where no consensus could be reached on the minimum necessary standards for an effective CFC system, there was a consensus recommendation on an Action 4 best-practices approach for preventing BEPS abuses regarding interest expense. The working group on this subject produced an Action 4 Final Report of 120 pages explaining the recommended approach and including about 25 pages of examples.

The Report notes that BEPS risks in this area typically arise in three basic scenarios:

> Groups placing higher levels of third party debt in high tax countries.
>
> Groups using intragroup loans to generate interest deductions in excess of the group's actual third party interest expense.

Groups using third party or intragroup financing to fund the generation of tax exempt income.

To address these BEPS risks, the recommended approach includes:

A fixed ratio rule which limits an entity's net deductions for interest and payments economically equivalent to interest to a percentage of that entity's earnings before interest, taxes, depreciation and amortization (EBITDA). Each country would set the fixed ratio in its domestic tax law. The Report's recommendation is that the fixed ratio would be set in a range from 10% to 30%.

An optional group ratio rule to supplement the fixed ratio rule. This would allow an entity with net interest expense above a country's fixed ratio to deduct interest up to the level of the net interest/EBITDA ratio of its worldwide group.

This recommended approach includes a number of options that countries could choose to apply. An update to the Action 4 Final Report was issued in December 2016.

Countering Harmful Tax Practices (Action 5)

This Action 5 has two principal concerns. First, it focuses on preferential regimes that can be used for artificial profit shifting. The regimes attracting the most attention currently are intellectual property regimes, often labeled "patent boxes", that a number of countries, especially in Europe, have instituted over the past fifteen years. Second, Action 5 considers the lack of transparency that exists in connection with certain rulings. The working group on this subject produced an Action 5 Final Report of a mere 85 pages.

In regard to preferential regimes, rather than recommending that they be eliminated due to their prior detrimental effects of providing a convenient mechanism for profit shifting, an agreement was reached to treat such regimes as not being harmful tax practices if they meet an agreed "substantial activity requirement". The idea was that meeting such requirements would mean that profits are aligned with the substantial activities that generate them. Presumably, countries maintaining such regimes will amend them as necessary to allow them to meet the agreed "substantial activity requirement".

Interestingly, on 13 October 2015, just over a week after the 5 October 2015 release of the BEPS final reports, Ireland's 2016 budget announcement included plans to create its own "knowledge development box" that would specifically meet the agreed "substantial activity requirement". Profits earned within this "box" would be taxable at a favorable 6.25% rate. As can be seen from this immediate reaction by Ireland, the agreed OECD BEPS approach further legitimizes this form of preferential regime.

In regard to transparency of tax rulings, the Report provides both best-practice recommendations for the ruling process including the publication of general rulings as well as a framework for the exchange with other tax authorities of taxpayer-specific rulings.

Preventing the Granting of Treaty Benefits in Inappropriate Circumstances (Action 6)

This Action 6 Final Report, a document of 106 pages, considers various abuses of tax treaties, the most important of which is “treaty shopping”. To counter such abuses, the Report sets out several approaches that recognize that different countries with their varying tax policy considerations will choose to adopt one or more of several possible approaches. These alternative approaches are each intended to provide a minimum level of protection against treaty shopping.

In brief, the approaches include both simplified and detailed versions of a “limitation on benefits” article as well as a “principal purposes test”. The Report includes extensive language drafted for inclusion in the Commentary to the OECD Model Tax Convention.

The anti-abuse rules included in this Report will be among the changes proposed for inclusion in the multilateral instrument that is the subject of Action 15. (See Part III of the Multilateral Convention released on 24 November 2016.)

Preventing the Artificial Avoidance of Permanent Establishment Status (Action 7)

This Action 7 Final Report, in its paltry 51 pages, focuses closely on certain legal but artificial structures used to avoid permanent establishment status under typical tax treaty provisions. By not having a permanent establishment, a foreign seller of products or a provider of services can normally avoid any taxation of income in the country of the customers or clients. If the foreign seller or service provider had conducted business in a more simple and direct fashion, it would likely have had a permanent establishment and would have been taxable on income attributable to that permanent establishment.

The Report sets out changes to both the OECD Model Tax Convention and the Commentary that will cause such artificial structures to be treated as permanent establishments, thereby allowing any attributable income to be taxed.

Structures and contractual arrangements that are covered by the changes include:

Commissionaire arrangements,

Situations where contracts which are substantially negotiated locally are not formally concluded locally but are finalized or authorized abroad,

Arrangements involving a local sales agent that is arguably an “independent agent” but which acts exclusively or almost exclusively on behalf of one or more closely related foreign principals, and

Structures, often involving the use of multiple corporations to fragment various business activities and functions, meant to technically qualify for exceptions to permanent establishment status allowed for short term construction and for certain defined local

activities that are supposed to be relatively unimportant, or in treaty parlance, only "preparatory or auxiliary".

The rules included in this Report will be among the changes proposed for inclusion in the multilateral instrument that is the subject of Action 15. (See Part IV of the Multilateral Convention released on 24 November 2016.) Further, additional work is planned in 2016 to consider how to determine profits attributable to permanent establishments, especially in light of the expansion of permanent establishments that should result from the changes set out in this Report.

Aligning Transfer Pricing Outcomes with Value Creation (Actions 8 – 10)

The Actions 8 – 10 Final Report, with 190 pages concerning transfer pricing issues, represents considerable work that started several years prior to the 2013 formal initiation of the BEPS project. This earlier work focused primarily on hard-to-value intangibles. The BEPS project expanded this earlier effort into additional areas.

The guiding principle that runs through this Report is that transfer pricing outcomes must be aligned with value creation. The implication, of course, is that transfer pricing analysis has often been used by MNEs that have attempted to support their BEPS structures with such analyses. A clear example of this involves many supply chain structures that place the bulk of the profits in a zero or low-taxed "entrepreneur" subsidiary that typically has few, if any, employees and that primarily claims its right to the lion's share of the profits by holding legal ownership or other rights to intangibles and by contractually assuming all commercial risks through intercompany agreements. In the words of the Report (page 9):

> … The arm's length principle has proven useful as a practical and balanced standard for tax administrations and taxpayers to evaluate transfer prices between associated enterprises, and to prevent double taxation. However, with its perceived emphasis on contractual allocations of functions, assets and risks, the existing guidance on the application of the principle has also proven vulnerable to manipulation. This manipulation can lead to outcomes which do not correspond to the value created through the underlying economic activity carried out by the members of an MNE group. …

The principal areas covered in the Report include:

Valuation of Intangibles

Allocation of Commercial Risks

Approach to Delineation of the Actual Transactions

Treatment of Low Value-Adding Intra-Group Services

Treatment of Cost Contribution Agreements

For all of the above areas, the Report includes extensive amended and new language to be inserted into the OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. Future work will be conducted on the profit-split method and financial transactions.

Measuring and Monitoring BEPS (Action 11)

It has been very difficult to make any accurate measurements of the amounts that governments around the world have lost from BEPS activities conducted by MNEs. Within its 272 pages, the Action 11 Final Report reviews indicators of BEPS activity and makes a number of recommendations that will expand the collection and improve the analysis of available data.

Mandatory Disclosure Rules (Action 12)

Action 12 recognizes the benefits to tax administrations and tax policy makers of tools designed to increase the information flow to them on tax risks. This Action 12 Final Report, covering 102 pages, provides a framework that enables countries without mandatory disclosure rules to design a regime that fits their need to obtain early information on potentially aggressive or abusive tax planning schemes and their users. There is no minimum standard and countries are free to choose whether or not to introduce mandatory disclosure regimes. The Report also provides recommendations for the development and implementation of more effective information exchange and co-operation between tax administrations.

Transfer Pricing Documentation and Country-by-Country Reporting (Action 13)

The 74 page Action 13 Final Report sets out a standardized three-tier approach for MNEs to provide information reasonably required by tax authorities to understand an MNE's business and its transfer pricing policies so as to help the authorities determine whether further audit work would be appropriate. The three tiers are:

> Master File – This file includes information on the MNE's organizational structure, a description of its businesses, its intangibles, and intercompany financial activities. In addition, this Master File would include a copy of the consolidated financial statements and information concerning any unilateral advanced pricing agreements and any tax rulings relating to the allocation of income among countries.
>
> Local File – This file includes information on each local entity and requires extensive information on local management, businesses conducted including any effects from business restructurings or intangible transfers, and key competitors. In addition, extensive financial information and information on controlled transactions would be required.
>
> Country-by-Country (CbC) Report – This annual report will provide for each tax jurisdiction in which the MNE does business the amount of revenue, profit before income tax and income tax paid and accrued. MNEs must also report their number of employees, stated capital, retained earnings and tangible assets in each tax jurisdiction.

> MNEs are required to identify each entity within the group doing business in a particular country and to provide an indication of the business activities in which each entity engages.

This three-tier approach is referred to as "transfer pricing documentation" and is set out in a new Chapter V of the OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. However, this three-tier approach goes considerably beyond being only a tool for various tax authorities to assess transfer pricing risk. The Report on page 9 states:

> This information should make it easier for tax administrations to identify whether companies have engaged in transfer pricing and other practices that have the effect of artificially shifting substantial amounts of income into tax-advantaged environments. The countries participating in the BEPS project agree that these new reporting provisions, and the transparency they will encourage, will contribute to the objective of understanding, controlling, and tackling BEPS behaviours.

As may be expected, there was some disagreement on what content should be included in the standardized template for reporting. For example, some developing countries wanted the CbC Reports to include related party interest payments, royalty payments and especially related party service fees. In overruling this request, it was agreed that countries participating in the BEPS project will carefully review the implementation of these new standards and reassess no later than the end of 2020 whether modifications to the content of these reports should be made to require reporting of additional or different data.

Regarding submission of these three documents, the Master File and the Local File are to be delivered by MNEs directly to local country tax administrations. CbC Reports will be filed with the tax authorities in the home country of each MNE's parent entity. Those authorities will then provide the CbC Reports to other countries through official channels such as the multilateral Convention on Mutual Administrative Assistance in Tax Matters, bilateral tax treaties, and tax information exchange agreements. As a secondary mechanism meant to be applied only in limited circumstances, local tax administrations could require an MNE to file the CbC Report directly with the local country tax administration.

The new CbC Reporting requirements are to be implemented for fiscal years beginning on or after 1 January 2016 and apply to MNEs with annual consolidated group revenue equal to or exceeding EUR 750 million. This 1 January 2016 start date may slip some since local legislation will be required in some home countries of MNEs before the MNEs headquartered in such countries can be required to prepare and submit CbC Reports. In addition, competent authority agreements and other actions may be necessary before there will be a smooth distribution of CbC Reports by the home countries to all interested local tax authorities in other countries. The initiation and timing of local submissions of the Master and Local Files will depend on each country's requirements since each country will have to enact local legislation or issue administrative procedures.

Two important recent developments on the implementation of CbC reporting have occurred.
First, in December 2015, the U.S. Treasury and IRS issued Proposed Regulation §1.6038-4,

Information returns required of certain United States persons with respect to such person's U.S. multinational enterprise group. This proposed regulation and useful explanatory material is available at https://www.federalregister.gov/articles/2015/12/23/2015-32145/country-by-country-reporting. In contrast to the recommendation in the action 13 final report that reporting should be initiated for fiscal years beginning on or after January 1, 2016, the proposed regulation would only be effective, at the earliest, for taxable years of ultimate parent entities of U.S. MNE groups that begin on or after the date of publication of the Treasury decision adopting these rules as final regulations in the Federal Register. As the earliest that this could happen would be sometime in 2016, this means that the earliest calendar year for which CbC reporting could be initiated would be 2017.

On 30 June 2016, the U.S. Treasury and IRS issued final regulations confirming this effective date approach. However, introductory material to the regulations indicates that a future procedure will be issued allowing voluntary filings of CbC Reports for periods before the effective date. The intended purpose of this procedure is avoid situations where another country would request, say, a calendar year U.S. MNE's CbC Report for 2016 directly from an MNE group member. Instead, if the U.S. MNE has made the voluntary filing, the other country would have to obtain the report through information exchange with the U.S. tax authorities. This introductory material and the final regulation are available at https://www.irs.gov/irb/2016-29_IRB/ar05.html.

Second, on 27 January 2016, the OECD announced the signing by 31 countries of the Multilateral Competent Authority Agreement for the automatic exchange of Country-by-Country reports. This announcement and a copy of this Agreement are available at http://www.oecd.org/ctp/exchange-of-tax-information/a-boost-to-transparency-in-international-tax-matters-31-countries-sign-tax-co-operation-agreement.htm. The U.S. has indicated that it does not plan to sign this multilateral agreement, but rather intends to apply CbC reporting only with countries with which it has concluded a bilateral tax treaty or other information exchange agreement.

Making Dispute Resolution Mechanisms More Effective (Action 14)

Because an efficient and effective dispute resolution mechanism to prevent double taxation is important, the Action 14 Final Report in its 50 pages has developed a minimum standard and a set of best practices for the resolution of treaty-related disputes under the mutual agreement procedure (MAP) included in tax treaties. There is also a planned monitoring mechanism to assure effective implementation.

A limited number of countries believe that mandatory binding arbitration is the best way to resolve some or all disputes arising under tax treaties. These countries, which number twenty in total, include, for example, Australia, France, Germany, Japan, the U.K. and the U.S. and account for a large majority of outstanding MAP cases. These countries have agreed to develop a binding MAP arbitration provision as a part of the negotiation of the Multilateral Instrument of Action Plan item 15. Only those countries desiring mandatory binding arbitration would use the provisions developed.

(See Parts V and VI of the Multilateral Convention released on 24 November 2016.)

Developing a Multilateral Instrument to Modify Bilateral Tax Treaties (Action 15)

A number of the results of the BEPS project involve amendments to existing tax treaties, of which there are several thousand. Because these existing tax treaties are virtually all bilateral instruments for which amendments must be separately negotiated, signed, and ratified in some manner, it is impractical to recommend changes that could only be slowly inserted into existing treaties over a period of many years. As a result, Action Plan item 15 explored the feasibility of a multilateral instrument that would have the same effects as a simultaneous renegotiation of thousands of bilateral tax treaties. A report with recommendations was issued in 2014.

This summary is from page 10 of the 58 page Action 15 Final Report:

> The 2014 Report … concluded that a multilateral instrument is desirable and feasible, and that negotiations for such an instrument should be convened quickly. Based on this analysis, a mandate for the formation of an ad hoc Group ("the Group") to develop a multilateral instrument on tax treaty measures to tackle BEPS … was approved by the OECD Committee on Fiscal Affairs and endorsed by the G20 Finance Ministers and Central Bank Governors in February 2015. The Group is open to participation from all interested countries on an equal footing and is served by the OECD Secretariat. The Group begun its work in May 2015 with the aim to conclude its work and open the multilateral instrument for signature by 31 December 2016. Participation in the development of the multilateral instrument is voluntary and does not entail any commitments to sign such instrument once it has been finalised.

On 24 November 2016, shortly before the above-mentioned intended completion date of 31 December 2016, the OECD released the Multilateral Convention, saying that more than 100 jurisdictions participated in it and that it should result in updating more than 2000 bilateral tax treaties for certain BEPS issues. A signing ceremony for the Multilateral Convention is planned for June 2017.

Although the Multilateral Convention and a lengthy Explanatory Statement provide many details, it is not yet clear how things will work in practice or how swiftly countries will make the many complicated notifications required and complete the ratification process. The Multilateral Convention and Explanatory Statement are available at http://www.oecd.org/tax/treaties/multilateral-convention-to-implement-tax-treaty-related-measures-to-prevent-beps.htm.

Results of the BEPS Project

Although the above descriptions of BEPS Actions cover a number of separate and independent areas, the OECD intends a holistic approach to countering BEPS behavior. The following is from the Actions 8 – 10 Final Report, page 11:

> The [transfer pricing] guidance is linked in a holistic way with other Actions. …, this guidance will ensure that capital-rich entities without any other relevant economic activities ("cash boxes") will not be entitled to any excess profits. The profits the cash box is entitled to retain will be equivalent to no more than a risk-free return. Moreover, if this return qualifies as interest or an economically equivalent payment, then those already marginal profits will also be targeted by the interest deductibility rules of Action 4. In addition, it will become extremely difficult to structure the payments to the country where the cash box is tax-resident in a way that avoids withholding taxes, due to the guidance provided on preventing treaty abuse (Action 6). Finally, a cash box with limited or no economic activities is likely to be the target of CFC rules (Action 3). With that, the holistic approach provided by the BEPS Action Plan will secure that the role of cash boxes in BEPS strategies is seriously discouraged.
>
> This holistic approach to tackling BEPS behaviour is supported by the transparency requirements agreed under Action 13. Transfer pricing analysis depends on access to relevant information. The access to the transfer pricing documentation provided by Action 13 will enable the guidance provided in this Report to be applied in practice, based on relevant information on global and local operations in the master file and local file. In addition, the Country-by-Country Report will enable better risk assessment practices by providing information about the global allocation of the MNE group's revenues, profits, taxes, and economic activity.

It is fair to say that many of the new mechanisms and rules identified by the BEPS project will be put in place to help tax authorities thwart BEPS behavior. Despite this, some persons have understandable concerns about whether the BEPS project will successfully and significantly reduce BEPS behavior in the future.

Reducing BEPS behavior can happen in two ways. One is that the tax authorities in various countries identify taxpayers using BEPS structures and reverse their beneficial tax effects by imposing additional tax. How successful will tax authorities be at identifying BEPS structures? Will they have sufficient information from the Master Files, the Local Files, and the CbC Reports, for example, to decide which taxpayer situations warrant further study and investigation? And will they have the personnel, sophistication and industry knowledge to be able to ask the right questions? Note in this regard that these reports are meant to allow local tax authorities to evaluate risk (i.e., the potential that a taxpayer might owe additional tax), but these reports are specifically not intended to be a sufficient basis for those local authorities to assess additional tax.

For tax authorities in many developing countries, the answers to some or all of these questions might be in the negative. Additionally, even where tax authorities have sufficient sophistication and industry knowledge, will they have the resources to have more than a small effect? Studies have indicated that a large percentage of MNEs conduct BEPS-motivated structuring. It is likely for the tax authorities in most countries that they will only have the resources and capacity to truly investigate a small percentage of the MNEs that appear to have high BEPS risk. Further, as local authorities begin to receive the Master Files, Local Files, and CbC Reports for a

number of MNE groups, they may in some cases be overwhelmed by too much information with too little in the way of resources to properly evaluate the available data.

The second way is that the many new BEPS rules may sufficiently scare the managements of MNEs and thus encourage them to significantly reduce their BEPS behavior. Will managements believe that a continuation of their current practices simply carries too much risk? Will the new rules have sufficient deterrent effect to make a meaningful difference?

For some of the reasons discussed below, some persons fear that the BEPS project will only be marginally successful.

One uncertainty that could have a major effect is how many countries will eventually buy-in to the BEPS results? How many will quickly enact recommended rules into local law? How many will sign and implement the multilateral agreement so that a substantial number of the more than 3000 existing tax treaties are updated for the new provisions? How long will the education process take for knowledge of the new rules to seep down to tax inspectors and others within local tax authorities who are responsible for the conduct of tax audits? These are serious and daunting questions.

Another issue that will affect the success of the BEPS project is that the OECD expressly limited the project to addressing flaws in the existing international taxation system. There appears to have been no effort made to seriously reflect on and discuss any wholesale changes that would materially improve the overall environment as described earlier regarding systemic issues and developments over the past few decades. It was noted in this earlier discussion that within the current environment, there is a strong motivation for MNEs' managements to conduct BEPS activities. This OECD limitation is, in a manner of speaking, a legitimization of the present system and a continuation of the current environment, thus resulting in no reduction in BEPS motivation.

Although not allowed to be discussed within this two year BEPS project, there are two other possible approaches that could actually change the environment and significantly reduce or eliminate the present strong motivation to conduct BEPS activities. These two approaches are the unitary and full-inclusion taxation systems. These two approaches go by various names including for the unitary system, a formulary system, and for the full-inclusion system, worldwide consolidation.

The unitary approach, which was specifically rejected by the OECD from the start of the BEPS project, would ignore the separate legal entity status of each group member and treat the MNE group as one centrally managed taxpayer. This reflects the reality of how most groups are managed and conduct their worldwide businesses. Combined taxable income would be calculated from the income of all group members and that income would be spread amongst the countries in which the MNE actually conducted operations on some allocation basis that fairly reflects the real activities conducted in each country. It should be acknowledged that any adoption of a unitary system would be a lengthy process requiring considerable effort to obtain the buy-in of all countries to the system and agreement by all countries regarding methods of

calculating taxable income and apportioning that income. (See Durst, 6938 T.M., A Formulary System for Dividing Income Among Taxing Jurisdictions.)

In regard to the unitary method, the 19 July 2013 "Action Plan on Base Erosion and Profit Shifting" issued by the OECD (available at http://www.oecd.org/ctp/BEPSActionPlan.pdf) states on page 20:

> Alternative income allocation systems, including formula based systems, are sometimes suggested. However, the importance of concerted action and the practical difficulties associated with agreeing to and implementing the details of a new system consistently across all countries mean that, rather than seeking to replace the current transfer pricing system, the best course is to directly address the flaws in the current system, …

The full-inclusion approach, which was ignored by the OECD, would be implemented by the home countries of MNEs imposing home country tax at the home country tax rate on the combined income of all group members no matter where incorporated or tax resident. A foreign tax credit would prevent double taxation. Any adoption of the full-inclusion approach would require at the same time consideration of stronger tax residency and anti-inversion rules. (See Kadet, "Worldwide Tax Reform: Reversing the Race to the Bottom", 138 Tax Notes 1245 (Mar. 11, 2013), available at http://ssrn.com/abstract=2231915.)

Either of these approaches would significantly reduce or eliminate BEPS motivation because 100% of an MNE's income, no matter where earned, would be subjected to tax with the level of tax not being affected by any intra-group contractual or structural arrangements.

Reflecting these concerns about the OECD having limited the scope of the BEPS project, the Economist on 10 October 2015 stated (available at http://www.economist.com/news/business/21672207-plan-curb-multinationals-tax-avoidance-opportunity-missed-new-rules-same-old):

> OECD officials were predictably upbeat as they unveiled the plan. Angel Gurría, the organisation's secretary-general, declared that it will "put an end to double non-taxation". Pascal Saint-Amans, the OECD's tax chief, said it marked a "change of paradigm" that should help to make tax planning "marginal" rather than "a core part of business models" (though he accepted there was still much work to do; two years is but a blink of an eye in global tax diplomacy). The reality is less cheering: the project was flawed from the start because it was impossible to achieve consensus in favour of the radical overhaul that was needed. The result is a patch-up job that offers improvements in certain areas but fails to deal with the core problems.

The Economist singled out the separate entity principal saying:

> The biggest disappointment is that, in opting to renovate the existing system, the OECD has stuck with its most deeply flawed pillar: the "independent entity" principle. This rests on the fictitious assumption that the various parent and subsidiary companies in a

corporate group act like separate legal persons that transact with each other at arm's length.

While some of the results in the BEPS 5 October 2015 Final Reports will clearly have a deterring effect on some BEPS behavior, the overall environment as described earlier regarding systemic issues and developments over the past few decades remain basically unchanged. As a result, there is still the same motivation for the managements of MNEs to aggressively seek out lower taxed income so as to boost earnings per share, share price, and their own equity-based compensation. The activities and tax structures of MNE groups will still be analyzed using the separate entity principle. MNEs will still have the full ability to contractually break-up their business activities amongst multiple group members and have the relevant tax authorities take that break-up seriously despite its having no substantial economic effect on the MNE, aside from the lower level of overall taxation. Outside advisors will continue to invest considerable time in developing artificial tax structures that can be marketed to many MNEs.

Because of the OECD's decision to continue the current system and its respect of the separate entity principle, the 5 October 2015 results of this two-year BEPS project are often complicated and convoluted approaches to limiting the worst excesses of BEPS behavior. Such approaches will, in some cases, make compliance more difficult for MNEs and enforcement difficult and particularly time consuming for under-resourced tax authorities that, as noted above, may not have specialists with sufficient industry knowledge to effectively audit and enforce taxpayer compliance. This will be particularly true in the areas of transfer pricing and hybrid mismatch arrangements that can involve entities and financial instruments.

It was noted earlier that the OECD has encouraged broad participation in the BEPS process by many counties. Despite this, it is fair to say such participation was limited. Further, it may be said that some participating countries carry more decision-making weight than others and that participating countries can have varying national interests and priorities. As such, on some topics, there can be apparent incongruous results, especially considering the lofty objectives of the BEPS project and the rhetoric of leaders that have championed the process.

Examples of BEPS project results that seem contrary to the overall objectives of eliminating BEPS structuring and will encourage its continuation include the continuation of harmful tax practices such as patent boxes, the limited efforts made with respect to the permanent establishment definition, the lack of any agreement on strong CFC rules, and the seemingly overly restrictive approach to distributing the new CbC Reports. In addition, although the G20 did not ask for this limitation, the OECD limited discussion and possible solutions by prohibiting any discussion that might change current source and residence taxation concepts that exist within the OECD Model Tax Convention. This restriction, for example, severely limited any ability to consider during this initial two-year BEPS project the very major issue of how to deal with the permanent establishment concept in the digital age. This issue is expected to be addressed in the future.

As a final general comment on the results of this initial two-year BEPS project, Lee Sheppard, a contributing editor of Tax Analysts' "Tax Notes" noted in an article some comments made by

Pascal Saint-Amans, head of the OECD Centre for Tax Policy and Administration, which was responsible for the BEPS project (80 Tax Notes Int'l 212 (OCT. 19, 2015)). She wrote:

> Saint-Amans used his lecture to explain how the OECD has improbably gone from enabler to quasi-enforcer and putative savior of the international consensus. He mentioned the financial meltdown and the [Lux Leaks] disclosures as catalysts, but … [did not mention the role played by] NGOs, citizen protests, austerity…. "International tax is getting sexy because of the financial crisis," he said.
>
> Saint-Amans described the final BEPS reports as an end run around the United States. The negotiators didn't want to create something that would fail if not implemented by every participant. The reports are engineered so that not all countries need implement the recommendations -- that is, some countries are just not going to have CFC rules. And the negotiators did not want to attack known transactions piecemeal while profits continued to be booked where no activity was happening. The results "will translate into more cooperation" while avoiding the first-mover dilemma, Saint-Amans said.

<u>The Future</u>

Looking to the future, there are a few points worth highlighting.

- The various BEPS Final Reports represent guidance for future actions and do not represent authoritative documents that can be enforced by any government on any taxpayer. In addition to these Final Reports, there will be important and extensive amendments to the OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations. While these Guidelines normally do not have any direct legal effect, they will be very important in the interpretation of transfer pricing issues in many countries.

- The various minimum standards and recommendations made in the reports require implementation. In some cases, this means local enactment through local legislation and administrative practice. In other cases, it will mean a successful conclusion of the contemplated Action 15 Multilateral Agreement and ratification of all or portions of that Agreement by countries around the world. Only in this manner will the various changes to the OECD Model Tax Convention and the Commentary arising from this BEPS project become effective for the thousands of existing tax treaties.

  There will clearly be pushback and lobbying by MNEs in many countries during local implementation, especially when legislation is required for implementation. As an example in the U.S., MNEs through organizations such as the National Association of Manufacturers (NAM) and the National Foreign Trade Council are already expressing strong concerns to what appears to be a very receptive Congress about the Action 13 Transfer Pricing Documentation and Country-by-Country Reporting requirements. NAM's written submission to the Senate Finance Committee, for example, urges Congress to ensure that the US Treasury would provide CbC Reports to a country "only if U.S. MNEs or their subsidiaries are not required to provide master file information to the foreign

country". This and other recommendations would emasculate, relatively speaking, much of Action 13's effect.

- As indicated for some specific areas above, work will continue over the next five years by the OECD and many member and non-member countries to further study certain defined areas and to monitor other areas for possible further changes. There will also be some monitoring through peer review of the manner in which specific countries implement BEPS deterrents.

- The above-mentioned local country implementation and ongoing OECD and other international organizational efforts will require considerable commitment and resources. It remains to be seen if the political will, which caused so many countries to invest time and energy into this two-year BEPS project, will continue into the future, thereby allowing both widespread local implementation and a similar or increased level of individual country involvement in the extensive follow-up work. The first such test of this will be the commitment of countries to the effort to develop the Action 15 Multilateral Agreement.

- Although not an OECD initiative, the European Commission and the European Parliament have been very active in reviewing BEPS structures in light of European State Aid rules and in considering possible internal European approaches to combat tax avoidance. This is a particularly important area to watch for future developments.

- The rhetoric of OECD officials is to ask for increased involvement of non-member countries including countries from the developing world. It remains to be seen whether such countries will be full participants or whether some may feel that their particular issues are not being sufficiently addressed, thereby causing them to develop different, and sometimes unilateral, solutions.

- Some countries are already taking unilateral action against some forms of BEPS behavior. Perhaps the two most publicized are actions taken by the U.K. and Australia. More recently, India has instituted an "equalization levy" directed at digital services, including online advertising. To the extent that there is less belief in the success of the BEPS project to truly curb BEPS behavior, increasing numbers of countries will likely take unilateral actions to protect their tax bases.

- Perhaps the most important future imponderable is the reaction of MNEs to the BEPS project. While it seems certain that some number of them will continue to push the envelope to achieve BEPS benefits, some are already taking actions showing that they take the BEPS project seriously and accept that they need to modify their past behavior. As an important example, it has been reported that Amazon, the major online U.S.-based retailer, has either already set up or is planning to set up taxable branches in the UK, Germany, France, Italy, and Spain. Previously, Amazon had booked sales and reported income in Luxembourg while claiming no taxable presence in these countries of sale.

- Discussion in the above "Results" section noted how the OECD limited the scope of this two-year BEPS project by choosing not to consider any wholesale changes that would materially change the overall environment as described earlier regarding systemic issues and developments over the past few decades. Rather, the OECD chose to merely

address flaws in the existing international taxation system. Looking forward, especially if MNEs continue to conduct BEPS activities that are only slightly abated from their present level such that the tax bases of many countries continue to be eroded, there will be continued calls for a longer term resolution that does change the environment and that would reduce some of the inherent strong motivations presently for MNE managements to conduct BEPS activities. This would make the two-year BEPS project only the first small step in a longer story.